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TAX REFORM ACT OF 1986, PART 2

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

FEBRUARY 3, 1986

(Alternative Minimum Tax Proposals)

(Part 2 of 5 parts)

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TAX REFORM ACT OF 1986, PART 2

MONDAY, FEBRUARY 3, 1986

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m. in room SD-215, Dirksen Senate Office Building, the Honorable Bob Packwood (chairman) presiding.

Present: Senators Packwood, Danforth, Heinz, Durenberger, Symms, Long, Bentsen, Moynihan, Boren, and Bradley.

[The press release announcing the hearing follows:]

[Press Release No. 86-006, Wednesday, January 29, 1986]

COMMITTEE ON FINANCE SCHEDULES FEBRUARY 3 HEARING TO REVIEW ALTERNATIVE MINIMUM TAX PROPOSALS

The alternative minimum tax provisions of H.R. 3838, the Tax Reform Act of 1985, will be reviewed by the Senate Committee on Finance at a hearing set for February 3, Chairman Bob Packwood (R-Oregon) announced today.

Senator Packwood said the hearing is another in a series he has called this year to consider components of the tax reform issue now before the committee. The chairman said the hearing is set to begin at 9:30 a.m., Monday, February 3, 1986, in room SD-215 of the Dirksen Senate Office Building in Washington.

The chairman said the committee would hear from witnesses invited to discuss House plans for alternative minimum taxes.

Individuals who are not scheduled to present an oral statement, but who wish to share their views with the Committee, may submit a written statement for inclusion in the printed record of the hearing, Senator Packwood said.

The CHAIRMAN. The committee will come to order, please.

This morning, we are hearing testimony on the subject of the minimum tax. And the reason we are considering that today is that the testimony we had on the minimum tax last summer on the administration's bill was probably not germane to the minimum tax the way the House has passed the bill. So this is one of the few subjects where we have asked witnesses to come back and to testify again on a subject we have previously covered, but it is now before us in such a different way that we almost regard it as sui generis.

As far as I am concerned and I think for many members of this committee they support a minimum tax, and the feeling being that everyone in this country who makes money as an individual, all corporations who at least make money, should pay some tax, regardless of their tax preferences. That if the public is going to conceive of the code as being fair, they cannot have stories of major corporations making immense profits and paying no taxes or wealthy individuals paying no taxes. That does more to discourage the public about the fairness of the tax system than all of the municipal bonds and others things that wealthy individuals may purchase in order to better society as a whole.

So I hope we can find some workable—and I emphasize workable—minimum tax that achieves the goal that most of the members on this committee would like to achieve without at the same time so distorting the income tax system as to make it a fraud.

Senator Long.

Senator **Long**. No statement, Mr. Chairman.

The **Chairman**. Senator Bentsen.

Senator **Bentsen**. If I might comment for just a moment here.

Mr. Chairman, as one of the early proponents of a tough minimum tax, I am still very supportive of that idea. I think it is absolutely essential to retain credibility in the tax system, so that everyone who makes true economic profit pays a tax. One of the things that destroys credibility in the tax system is for some fellow making $35,000 a year and paying a substantial portion of his income in taxes, to read in the morning paper about someone making a very substantial amount of money and not paying any tax, or about corporations making hundreds of millions of dollars and not paying any tax.

But one thing concerns me a little about what I see happening on the House bill. They have substantially raised the rate. Most of the bills that those of us on the committee have introduced have been in the range of a 15-percent minimum tax, the objective being to ensure that those who make an income pay a tax. Our objective has not been to find a large alternative source of income for the Treasury.

Now we see the rate moved up to 25 percent in the House bill, and we see the difference between the alternative minimum and the regular corporate or the individual tax substantially narrowed.

Now what kind of an effect does that really have? Are we in a situation where we are now getting two tax systems running side by side? And is the objective of the minimum tax really to raise revenue? As I recall, the House minimum tax would raise about $25 billion in revenue over 5 years, which some around here would say was not significant, but I haven't been here that long. I still think that is quite a significant amount of money.

So that is voicing my concerns early, and I would hope that the distinguished gentlemen before us would address themselves to that.

The **Chairman**. Senator Moynihan.

Senator **Moynihan**. Briefly, Mr. Chairman, to welcome our distinguished panel, and to welcome your remarks, your observation, that a majority of this committee is in favor of a minimum tax because we have a good one in S. 956, Senator Chafee and I. It was just as good 3 years ago when in the back room there a majority of the committee, very barely, decided it was not in favor of a minimum tax. You remember the vote was 9 in favor and 10 against.

It was one of those things, Mr. Chairman, which needs to be better understood. There are just too many rich people out in that hallway that they didn't want to pay it. And if that was the case, we sure didn't want to inconvenience them.

I think we wish we hadn't done that now. I know what side you are on. If you call Senator Dole, he said, all right, in that case, the depreciation schedule for real estate goes from 15 years to 20 years, as if—not meaning to point any fingers but making very clear what he thought had happened. And we compromised at 18 in conference.

But we let that opportunity slip away from us once. I am sure we won't do it a second time. And I look forward to hearing the panel.

The CHAIRMAN. Gentlemen, your statements in their entirety will be in the record. We have asked you to abbreviate and orally to hold yourself within our 10-minute time limit so that we might ask questions. We will take you in the order that you appear on the witness list, and that will be Mr. Byrle Abbin, Mr. Victor Zonana, Mr. John Hamm, and Mr. Donald Schapiro.

Mr. Abbin.

STATEMENT OF BYRLE M. ABBIN, DIRECTOR, OFFICE OF FEDERAL TAX SERVICES, ARTHUR ANDERSEN AND CO., WASHINGTON, DC.

Mr. ABBIN. Good morning. Mr. Chairman, my name is Byrle Abbin. I am managing director of the Office of Federal Tax Services of Arthur Andersen and Co. I thank you very much for giving me the privilege to present my views on this subject.

The AMT, as we have reviewed it from H.R. 3838, is one of the most far-reaching of the tax reform proposals. It is very persuasive and in conflict with our basic income tax system.

Following through with the comments by Senator Bentsen, the AMT needs better to be coordinated with this basic income tax system. I am going to be focusing on the House bill, but what I have to say applies to any AMT system that has the combination of a very broad base and a high rate that in essence, can make it a separate new tax system for a significant number of businesses and individuals. As a result, it can be perceived as a backdoor approach to a very broad-based, flat-rate tax system as it is presently structured in the House proposal.

Certainly I will acknowledge the political support, and the statement you have all made about the perceptions of fairness are to be considered in this context. So my comments relate solely to making the system operate effectively and fairly within the context of our current income tax system.

Unless the considerations about its broad base, high rates are considered—and at present time, the AMT under the House proposal is roughly 70 percent of the basic rate. And under the President's desires for even lower rates, it can approach about three-quarters of that tax system—it will be significantly burdensome to create a perception that it by itself is unfair.

It will encourage perhaps even business combinations of emerging and startup companies, because of the problems of coping on their own to which I will allude in a moment. It even might discourage individual investment.

Initially, my concern is about the impact that is greater on emerging and startup companies because they are not allowed to offset their high rate AMT by business credits, especially the R&D credit. Thus, I would suggest that the approach by the House will competitively favor the larger, older, more mature competitors. As a result, it penalizes high growth, high investment, high risk businesses. That, by itself, is something that I strongly consider you reflect and relate as you go through your process.

Next I would like to point out that there was a great deal of controversy and concern over the Treasury's windfall recapture depreciation provision; thought that it would be significantly unfair. And as a result, even the House rejected that proposal in spite of the many billions of revenue that were at stake.

Nevertheless, the House continued a windfall recapture this time in the form of investment tax credits that were earned under the present law, but not able to be utilized, and, therefore, subject to carryover.

We are dealing with at least $30 billion of investment tax credits under the current law that were properly earned based on investment made during the years of high inflation, high interest rates that with the business downturn could not be fully utilized. Nevertheless, as is now proposed, none of those carryovers can be used against the AMT. As a matter of fact, many companies will be put in a trough where over a period of time they will continue to pay the 25 percent tax, never utilizing the $30 billion and eventually these credits, by their own limited term under the current law, will expire.

And I ask you: Is that really fair to allow someone even encourage them to make investments based on a system, and then retroactively take it away through another different tax system that is evolving to a very high rate, broad based AMT?

Another aspect of what I consider the recapture umbrella is looking at commitments made under the current law for investments, perhaps primarily by individuals, where they either made an investment with current cash and/or made legal commitments to add to that cash investment over a period of time, quite often as concerned or described as stage payments.

Under the proposal, there is a cap, a $50,000 limit put on that amount of deduction in spite of real economic loss.

And my point, therefore, is that when you look at what we are dealing with, is it appropriate to deny under a tax system deductions for real economic losses through artificial caps, especially for commitments made at the time based on assumptions about rate of return in the tax system that all of a sudden at this point in time would be retroactively taken away.

I suggest considerable thought ought to be given in any context of an AMT that anything that was earned under the prior law should be allowed a fresh-start approach just as we are doing in the proposals or new items included in the preferences, be they tax-exempt income that is included or new issues or completed method of contract, et cetera, so that items that were encouraged under the prior law will continue on a binding contract basis. To put it more simply, there ought to be an umbrella over amounts that are invested based on the law and not arbitrarily taken away through a new tax system that is proposed under the House bill.

There is confusion of measurement of income tax base. Reference has been made to taxing economic income. That is a difficult concept both in the measurement and the timing of payment. And especially is this a problem when you look to some of the items being included.

For example, a not-very-high executive, perhaps a second vice president engineer in a Silicon Valley company, may exercise an incentive stock option, have to pay an AMT; later on sell that stock and pay a second tax. There is no coordination to that system for double taxation.

The proposal for an AMT credit is just not sufficient to take care of that.

Likewise, the loss on economic investments that I have mentioned is a confusion between both timing and when a loss ought to be allowed. And putting an artificial cap especially on back investments that are made under the current law seems an inappropriate confusion of how to measure the ability to pay.

My conclusion is very simple. That one must look at a system recognizing the political realities that an AMT is necessary for the perception of fairness, but not allow it to go to such an extent whether it is an effort to raise taxes, to zero in on those abusers that you are very concerned about, and not realize that in that process you will be creating a completely separate and second tax system that presents great difficulties in determining how to make an investment, two sets of books for every investment made, both by companies and individuals, and do not carry a single track along the way. It will create great burdens both in investment and also in perhaps the administration of the tax system by the Internal Revenue Service.

To answer the needs for the fairness, I would suggest relenting back to where our current AMT is for individuals today. And that is when I am speaking of proportionality. The AMT ought to be an appropriate portion of the basic income tax. Today that is 40 percent for individuals, that is, the 20-percent rate compared to a basic 50.

Senator Bentsen mentioned a 15-percent rate. Senator Moynihan already has the 15-percent rate on the books.

When you look at the current top rate that is proposed to be between 33 and 38 percent, you take a pick of whose approach is likely to prevail, I would suggest that the proportionality would say a 14 or 15 tax is an appropriate one based on our current system. When you go beyond that and get into the proportionality that is up to 70, 75 percent, you will find that a great number of both businesses and individuals will be caught in that AMT trap forever and many elements of our basic income tax system, therefore, essentially are ignored.

We must look at the harm it will do to emerging, start-up, high-technology companies, and not put them at a competitive disadvantage with our more mature companies who will not be as affected by the AMT system.

We must not allow the system to revoke many present elements of our tax system, be they tax credit carryovers or individual investment commitments. It must not be so focused on revenue raising, but rather let us get to the policy reasons for its existence to create an image of fairness and hopefully also simplicity to take care of the political problem.

And in conclusion, I think we need a better integrated AMT that is not retroactive but is proportional to the current system.

Thank you very much for you attention.

The CHAIRMAN. Thank you.

[The prepared written statement of Mr. Abbin follows:]

STATEMENT OF BYRLE M. ABBIN

MANAGING DIRECTOR AND PARTNER

OFFICE OF FEDERAL TAX SERVICES

ARTHUR ANDERSEN & CO.

WASHINGTON, D.C.

Presented before the Senate Finance Committee
Hearings on the Alternative Minimum Tax

February 3, 1986

ALTERNATIVE MINIMUM TAX

Mr. Chairman my name is Byrle M. Abbin. I am Managing Director of the Office of Federal Tax Services of Arthur Andersen & Co., a worldwide accounting, auditing and consulting organization. While many of our clients would be affected by the Committee's decisions on tax reform, the views presented today are those of the firm itself.

The alternative minimum tax (AMT) may turn out to be one of the most far reaching of any provision in H.R. 3838. Despite the wide political support for a minimum tax, proper consideration has not been given to integrating the AMT with the income tax system so that the objectives of that system can still be realized. As a result, the AMT is evolving into a mechanism with too many purposes. The roles it is being called on to perform include:

- to force a prepayment of income tax that would eventually be paid under the regular tax system;
- to blunt the effect of tax incentives specifically adopted by Congress;
- to force individuals out of tax shelters (including those that are legitimate, economic investments), and into more traditional, more passive investments;
- to initiate a tax on types of income that would not be taxed under the regular tax system;

- to make everyone pay a "fair share of tax," and
- to raise revenue.

As such, the AMT would become a powerful, pervasive feature of our tax system, but not necessarily a embodiment of sound tax policy.

It is worthwhile to note that an AMT will not move us to a more perfect or even necessarily a more fair tax system. As a matter of fact, as some in this committee have noted in recent months, real tax reform reduces the need for a minimum tax. The headlong rush of some in Congress to embrace a minimum tax could be construed in that context as a public and enthusiastic admission of defeat of the tax reform process before it has even begun. Before looking at features of the AMT as proposed, it is important to review some of the myths and the realities about the AMT.

- An AMT will assure that everyone pays a "fair share" of taxes.

  Probably not, because we have no consensus on what constitutes a "fair share."

- An AMT will assure that everyone pays some tax.

  Probably not. Taxpayers (particularly corporations) with real economic losses will probably pay no tax, and most would agree they shouldn't.

- An AMT will eliminate tax shelters.

Probably not. There are "bad" shelters and "good," economic shelters. The "good" (i.e., non-abusive) shelters will no doubt continue, although an AMT may change the economics of these investments vehicles. Ironically, the way the AMT operates will allow well-to-do investors to continue using shelters relatively unscathed whereas the moderate income investor is more likely to be affected.

- An AMT will eliminate use of preferences.

As proposed, the AMT cannot and should not completely eliminate use of any preferences. If their use should be eliminated, they should be eliminated from the regular tax. Taxpayers will still be able to use preferences, so long as they have sufficient income with which to offset the preferences. The overall effect of this will be to put emerging companies as well as high growth, high investment companies at a competitive disadvantage relative to more static companies.

- The AMT cannot be avoided.

This statement may be true. Nonetheless, even if AMT cannot be avoided, it can still be carefully planned for. This planning will require a great deal of effort and result in uncertainty from having to plan every investment under a two-track system. This would affect virtually every corporate and individual investment plan.

But is it bad if the AMT does not exhibit all of these qualities? Probably not. To satisfy each of these objectives would require an AMT that engulfed the regular tax system and reversed many of its fundamental notions of fairness. But that would not be an AMT that operated as a complement to the income tax system. It would be something else entirely -- a new tax, measured against a new base, not related to "income" as most people understand it today. It might be considered fair as a new tax, but it would not be acceptable as part of our income tax system.

This committee should resist the urge to expand the AMT into a completely new tax. Instead, it should focus its efforts on clearly defining the role of the AMT and designing one that achieves that limited purpose. In doing this, the discussion of AMT must proceed on the basis that its present conceptual underpinnings are flawed. The AMT presented in H.R. 3838 has additional structural flaws, as well, some of which deserve comment. Other, more technical flaws -- and there are many -- will not be mentioned, but we will be pleased to work with your staff in identifying them.

Incidence of AMT: Rates and Who Will Pay

Simply and unequivocally stated, the proposed 25% AMT rate is too high in a tax system where the maximum individual and marginal corporate rates are less than 40%. This very narrow differential between the rates would inevitably put large numbers of taxpayers under the AMT system, even though they might pay significant taxes under the regular income tax. To put this in perspective, a corporate taxpayer with $150 million of book income and $100 million of taxable income would pay AMT, even though its regular tax liability would be $36 million. Is this really the type of company that should be subject to a minimum tax system? After all, $36 million is an effective rate of 24% of book income, and certainly constitutes more than a nominal amount of taxes paid. The AMT, as applied to this company, and other companies that pay fairly significant amounts of tax, actually operates as a means to increase the tax burden. This is completely different than the perceived objective of the AMT, namely to prevent companies from paying little or no tax.

In addition, the compression of rates gives the AMT the appearance of being a "back door" means of moving to a flat-rate tax system. Since the minimum tax was enacted in 1969, the tendency of legislators has been to expand the base of preferences. True to this pattern, the proposed AMT substantially expands the current taxable base. If the AMT is imposed at a high rate, and there is an ever broader base to which the tax applies, then naturally, more and more taxpayers would be swept into the flat-rate AMT system. As this occurs, the familiar tax doctrines by which fairness is measured (progressivity and ability to pay) are eroded. If it is the objective of Congress to move slowly toward a broad-based, flat-rate system, then that objective should be articulated at the outset, rather than occurring by default by increasing the scope of the minimum tax. In that context, note that the addition of preferences makes it increasingly difficult to coordinate the AMT and the regular tax. As the base grows, the more the AMT becomes a new and separate tax system.

Who will pay the minimum tax? The AMT will fall most heavily on those who have a high proportion of preferences relative to total taxable income. For example, assume two independent oil producers, each of whom incurs $4 million of preferences attributable to percentage depletion. One taxpayer has $6 million of pre-depletion taxable income, and the other taxpayer has $12 million of pre-depletion taxable income. Who will pay the AMT? Some would say both, because both make equal use of preferences. That is not how the AMT operates.

Only the taxpayer with the greater proportion of preferences relative to taxable income would pay AMT. In our example, it would be the taxpayer with $6 million in taxable income. Even though our experience with a progressive tax system might suggest that the taxpayer with twice the income should pay at least twice the tax, the AMT would not achieve that result. Thus, it can be seen that there is an element of unfairness that taxpayers will perceive. This will provide the impetus to plan very carefully the relative distribution of preferences to income so as to avoid the perceived unfair result.

Another example might compare two manufacturing companies that make similar products. Company A is profitable, has been in this line of business for many years, and uses a reliable, efficient, but slightly outdated technology. Company B is new, not yet very profitable, growing, aggressive, and is making a substantial investment in robotics. Which is more likely to pay AMT? Surprising as it may seem, it is the growing company, again making a substantial investment relative to earnings, and again responding to investment incentives designed to promote growth. The more static Company A, even with an AMT, can plan its rate of return much more reliably than Company B. Company B, barely out of a start-up mode, can not reliably predict its revenues, and, since it doesn't know whether it will pay regular tax or AMT, can not forecast a rate of return on its investment or be certain that its investment in the future will pay off. If Company B must pay AMT, its management must be able to see the rationale for paying what it might perceive as a penalty tax on growth. Otherwise, the perception of unfairness continues.

This dichotomy of stable, mature companies unaffected by the AMT and emerging, growth, high investment companies facing the uncertainty of an AMT could have an unintended result. It may lead to increased conglomeration of business so that intended tax incentives can be fully realized.

A simple, yet effective, solution to these problems would be to reduce the rate of AMT. Under current law, the relative proportion of the AMT rate to the maximum regular rate is 40% (or 33% for corporations). In H.R. 3838, the relative proportion is 66% for individuals and 69% for corporations and goes over 70% if the President's proposed tax rates of 35% and 33% (for corporations) are adopted. A workable solution that could still achieve the objectives of an AMT would be to simply lower the rate to something like its current proportion to regular tax. If this proportionality test were adopted, the AMT rate would be approximately 15% for individuals and corporations. The Joint Committee on Taxation has noted that a workable proportionality ratio would be to impose AMT at one-half the regular rates. Even this would be a great improvement over the 70% proportions of H.R. 3838.

Incentive Credits

H.R. 3838 permits incentive credits (investment tax credit (ITC), the R&D credit and the targeted jobs credit) to offset the AMT only in situations where a regular corporation has experienced a net operating loss in two of the three taxable years ending in 1983, 1984 or 1985. The Ways and Means Committee was on the right track in permitting these incentive credits to offset the AMT, but the net operating loss limitation should be removed. It will unfairly eliminate the use of credits by all but a very small group of loss companies. (Note that even if the ITC is repealed, many taxpayers will earn ITC under transition rules or will still have unexpired ITC carryovers, estimated at $30 billion for corporations.)

Assume a taxpayer has $1 million of taxable income, no preferences and has ITC carryovers. Assuming a 36% rate, this taxpayer would incur a regular income tax liability of $360,000, which could be reduced as low as $83,750 by available ITC. The AMT, however, will prevent a reduction below $250,000. Thus, in a situation where the taxpayer has no preferences, the AMT will come into play, and will prevent realization of an incentive clearly intended by Congress.

The same result would occur if the taxpayer were entitled to R&D credits. Assume that A and B both use R&D credits for research into toxic waste cleanup technology. A is a large chemical company with only one division engaged in this research. B is a modest-sized bioengineering firm with a very substantial allocation of resources to R&D expenditures. R&D expenses will not be a preference for these two corporations. In each case, however, the R&D credit would not offset any potential AMT. The result? The small, growing company is more likely to be penalized by loss of the value of the credit than the larger, integrated company. This seems an incongruous result.

Returning to the earlier examples of manufacturing companies, we can see that the combination of a high AMT rate and the loss of the use of incentive credits will almost inevitably give the AMT the appearance of being a thinly disguised revenue raiser instead of a safety valve that complements the tax system. The President has said that he would veto any new tax created within the context of the tax reform plan. The proposed AMT, in its current configuration, comes dangerously close to operating as an new tax, rather than part of our current tax system. The very high rate and the absence of a mechanism to permit use of available incentive credits will inevitably create a much larger class of taxpayers to whom the AMT would apply. Originally, only a limited number of sophisticated individuals and corporations had to make AMT computations. Even today, with the individual AMT rate at 20% and the top individual rate at 50%, a growing but manageable number of individuals must make the computations. As rates converge, however, more and more taxpayers, both individual and corporate, would be swept into the class of those required to make the AMT computations. The solution to this problem is to permit all incentive credits to offset AMT in the same proportion as they offset regular tax liability, and to eliminate the House rule limiting the offset to a small group of loss companies.

The problems with the rate and the credit alone are sufficient to indicate that the mechanism of an AMT is not well integrated, or consistent, with the income tax system. These problems also make it clear that an AMT is not a complete solution to the problem of fairness. While it is true that the proposed AMT would bring more individuals and corporations into the tax system, it is essential to the integrity of the income tax system and the AMT that those taxpayers understand why they are paying this particular tax, and why they must comply with the additional compliance burdens of computing their taxes under two very different schemes. They must understand why a specific incentive is provided under one system and then taken away in the other system. Otherwise, the charge of unfairness might properly be made against the AMT and one of the fundamental goals of tax reform -- providing for a fair tax system -- will have eluded the Congress.

Retroactive Application

Retroactive applications of any new tax law are almost always perceived as unfair, and have the effect of undermining the integrity of the tax system. Of particular concern in the AMT then, are two provisions that, as drafted in H.R. 3838, will have retroactive application. The general business credit offset rule relating to ITC and the R&D credit just described is one of those retroactive applications. Even if the ITC is repealed, there will be many taxpayers who will still have transition ITC or unexpired ITC carryovers available for use in years after 1985. Failure to make adequate provisions that will permit taxpayers to use carryovers of general business credits against their AMT liability will erode the value of those incentives. Some could be entirely lost if they expired before they could be used. In this context, it is irrelevant whether the credit is an appropriate incentive. The important point is that taxpayers made investments or undertook research in years before 1986 in full reliance on the laws that were in effect at that time. Thus, any corporation that has general business credit carryovers made its investment based on the availability of promised incentives and their effect on cost of capital and rates of return. Eliminating or eroding the planned economic value of investments already in place seems patently unfair. It is important to note that the retroactive effects will be felt not only by large corporations, but the provision could also harm small emerging companies with general business credits and individuals, primarily farmers, who have ITC carryovers, and who are likely to be subject to the AMT.

A second retroactive application of the AMT is found in the new preference for passive activity losses. This new provision appears to be aimed primarily at so-called "tax shelters," but could, in fact, apply to any leveraged passive investment of a taxpayer. This new preference has many structural and conceptual flaws, but certainly the most harmful of them is its retroactive application to existing investments. Assume that in the years 1983 to 1985, a taxpayer invests in various real estate and oil and gas production limited partnerships. For purposes of the example, assume that these are not abusive tax shelters, and that there are sound economic reasons for making the investment. Assume further that no cash investment is made in 1986. The House bill will treat any losses in excess of $50,000 as a preference. Thus, assume that the total cash basis is $100,000, and that in 1986 $90,000 of net losses are allocated to the investor. The AMT preference would be $40,000, even though the actual cash investment made prior to the AMT effective date was $100,000.

The example illustrates two important facts about the preference. First, actual cash losses can be taxed as a preference. This result arises because an arbitrary limit of $50,000 has been imposed on passive activity losses from tax shelters. The second problem is retroactivity. Under the facts assumed, no cash investment was made in 1986, but the new preference will still apply to pre-1986 investments. Therefore, even though the investment was made in reliance on tax laws in effect at the time of the investment, the new AMT preference would change the economics of the investment by denying a tax deduction for losses directly related to it. Similar results would apply to an investment that required "staged" payments. (These are contractual arrangements where an increment of cash is invested each year or period of years, e.g. every two or three years.) Note that in this situation, there may be cash investments after the effective date for the AMT, but the contractual agreement to make those investments actually arose before the effective date.

This retroactive effect could be mitigated by including in the AMT preference base only those losses attributable to investments initially made after the AMT effective date and by providing a "binding commitment" exception. H.R. 3838 provides a "fresh start" for other new preferences such as the preferences for tax-exempt interest, for the completed contract method of accounting, and the accelerated depreciation by corporations on personal property.

Double Taxation

The House bill provides a mechanism called the "AMT credit" to mitigate the potential effects of double taxation that could arise as a result of the AMT. The AMT is really a form of prepayment of taxes. The regular income tax system permits taxpayers, in effect, to defer taxes by accelerating many deductions or delaying the recognition of income. The AMT has the effect of eliminating some of that tax deferral and, to that extent, becomes a prepayment. The credit mechanism is a way of reflecting that prepayment when the taxpayer's situation has "returned to normal," i.e., when the taxpayer is paying regular tax again. As a practical matter, though, this AMT credit is inadequate to deal with the double taxation problem.

The preference for incentive stock options illustrates this problem most clearly. In the year an option is exercised, the taxpayer will have a preference. The preference amount is for the so-called "bargain element," or the spread between the option price and the fair market value of the stock. Assume, for example, that the option price is $10 and the fair market value of the stock at the time of purchase is $15. The preference amount will be $5. In a later year, when the taxpayer sells the stock for a gain, that same spread will be included in the AMT base again as a capital gain. Thus, for example, if the taxpayer sells the stock for $25, the capital gain will be $15, i.e., the $5 bargain element plus an additional $10 appreciation in value after the option was exercised. The solution to this particular double taxation problem, and to others, as well, would be an adjustment for AMT purposes that would reduce the gain by the amount of the preference ($5 in our example) that has previously been included in the AMT base.

Conclusion

The Senate is unequivocally on record as favoring a "stiff" minimum tax to assure fairness and to act as a safety valve to prevent taxpayers with economic income from avoiding tax. The House-passed version of the AMT, however, is simply inadequate to enhance the perception that our tax system is, in fact, improved with the enactment of an AMT. This is not because it is too lenient but because it operates in ways that will be perceived as contrary to fair tax principles.

In the case of individuals, the AMT could tax actual cash losses, could result in double taxation, or could simply be perceived as a penalty on investments both in a particular year and over time. In a business setting, the AMT adds another additional layer of decision making to any investment analysis. Moreover, as presently structured, the tax appears more likely to fall on a company that is growing and investing than it would on a company that is relatively static, but that is profitable. If, in fact then, an AMT is going to be enacted merely as a concession to a political reality, we urge the Finance Committee to coordinate the AMT carefully with the objectives, incentives and principles of the income tax system, and not expand it to the point where it becomes a new tax.

The **Chairman**. Mr. Zonana.

STATEMENT OF VICTOR ZONANA, PARTNER, KAYE, SCHOLER, FIERMAN, HAYS & HANDLER, NEW YORK, NY

Mr. **Zonana**. Thank you, Mr. Chairman, members of the committee.

For the record, my name is Victor Zonana. I am a tax lawyer. I am a member of the law firm of Kaye, Scholer, Fierman, Hays & Handler in New York City, and I am appearing here today in my personal capacity; not on behalf of clients or any organization.

In my remarks this morning, I would like to focus on the alternative minimum tax proposals of H.R. 3838; particularly, as they deal with individuals. I will focus specifically on three items: One, the various items of income deduction and exclusion that make up an item of tax preference; second, I would like to focus on the structural changes in the alternative minimum tax, which is part of the House bill; and, third, on the effective dates of the proposed changes. I will not get into an extensive technical discussion of the provisions of H.R. 3838 that deal with the minimum tax.

As an initial matter, I think it is worth it for us to take a few minutes to focus on what the role of the alternative minimum tax is or ought to be. It has been with us in the Internal Revenue Code since 1969 and has gone through many changes and transformations in terms of how it works and who it is directed at and what it is trying to do.

In its present form, we are told by the Joint Committee on Taxation's staff in 1983 the minimum tax raised $2 billion from approximately 235,000 taxpayers. We justify generally the minimum tax on the theory that we have a concern about a number of taxpayers out there who have high economic income who through the perfectly legitimate use of deductions, credits, exclusions that are now in the Code are able to reduce their tax levels to a very, very low amount, and are not, therefore, perceived to be paying their fair share.

To meet the concern about the fair share, we have an alternative minimum tax in the system. I suppose that as a theoretical matter perhaps what we ought to do is reexamine every one of those items that lead to the various incentives in terms of deductions, exclusions and create the distortion where these taxpayers are not paying significant amounts of tax.

On the other hand, I think the political reality is such that we are not prepared to do that, and the best approach today is to tackle the problems of those taxpayers not paying their fair share through the alternative minimum tax.

When you sit down and evaluate what H.R. 3838 does—and that is the House bill—I think you have to ask yourself the extent to which the House bill has deviated from what the minimum tax is doing today, which I believe is simply to raise a very minimal level of tax from those individuals who are using these various preferences.

The major shift, I think, that has occurred in the House bill is that we are no longer looking at a situation where taxpayers who have used preferences will be paying some minimal amount of tax, but I think the shift has been to that they will now be paying a significant amount of tax. And the reason they are to be paying a significant amount of tax, I believe, is because it is now our perception that a fair share is a significant tax as opposed to a minimal tax. And I think that is the problem that H.R. 3838 is addressing.

Let me turn to the items of tax preferences and just what the House has done with those items.

Essentially what it has done is to broaden the base to widen the net of the items of tax preference. In particular, we now have included as an item of tax preference the income from certain tax-exempt bonds or so-called nonessential bonds. We have also included as an item of tax preference some of the deferred income on foreign sales company income and also an item which will likely be controversial, and that is the untaxed appreciation relating to charitable contributions of appreciated property. That, now, is an item of tax preference.

As far as I am concerned, I think all of these additions, if the view is to create a broad-based net for the alternative minimum tax—I think those are justifiable.

There is one particular item which is going to prove to be very controversial, and it is not really set out there as an item of tax preference but enters into the mechanism of computing alternative minimum taxable income. And that is the so-called excess passive activity loss, which will prove to be, I think, probably another one of the controversial items in the minimum tax.

To make sure we understand what that item is about, I think we can state it quite simply. What it is saying is that for alternative minimum tax purposes—not for other purposes, but just for purposes of that tax—the passthrough losses that are derived from investments in tax shelter limited partnerships will be allowed only to the extent of the income that is generated from those investments, plus a certain amount equal to the lesser of the cash that is actually invested in those deals or $50,000.

That is really what it is trying to do. It has, in effect, created for purposes of the alternative minimum tax a separate basket, if you will, in which tax shelter gains and losses will be counted. And to the extent that your losses exceed your gain, they will count as an item of tax preference for purposes of the alternative tax.

The question is is this bad. Is this something that we all should object to because it is undesirable in some respect?

In my view, I think that is a correct approach insofar as the minimum tax is concerned. What we are trying to do is to ensure that taxpayers wind up paying a fair share of tax, however one defines fair share, on what is substantial economic income. And the losses that are sustained through these partnerships, in many instances, are not real losses. The approach taken by the House Ways and Means Committee and reflected in the House is that those losses are reflected when there is a disposition of the asset; when there is a disposition of your interest in that limited partnership. And, in effect, it eliminates the passthrough for purposes of the alternative minimum tax.

I do not think that that is a bad approach. I think it is perfectly evident to me that today the number of taxpayers—there is a large number of taxpayers who are avoiding the payment of significant taxes or even minimal taxes through tax shelters, and that is what the alternative minimum tax is trying to get to. And I think this does it. It may not be the most elegant way to go about doing it, but it certainly is hitting where it should be hitting.

Once you accept the proposition that losses from tax shelters should be limited to the income of tax shelters for purposes of the alternative minimum tax, it seems to me that the arguments that you will hear about increasing the cash basis or increasing the $50,000 amount really are simply an appeal to a de minimis rule, if you will. They are appealing to you and telling you that they would like to have a little bit more of those losses passing through for purposes of their regular tax as opposed to let's limit it to just the amount of income that is being generated from those investments.

I think this is a difficult item. It is a controversial item, but I think it is an appropriate approach as far as the alternative minimum tax is concerned.

The House Ways and Means Committee and the House in H.R. 3838 have also made some other changes in the structure of the alternative minimum tax, in particular by introducing a credit mechanism, which I think is appropriate, and by changing the rate. The rate has moved up to 25-percent. My own view as far as the rate is concerned is that it is probably—it strikes me intuitively that it is on the high side; that it should be somewhat lower than the 25 percent that is now set out there. And I have discussed the reasons for that in my written testimony.

What does concern me as far as the high rate is concerned that we are, in fact, creating two systems and two very complicated systems. As opposed to having a simple system as far as the alternative minimum tax is concerned, which would have a rather broad base for purposes of measuring income, and then applying a relatively low rate or a lower rate than the 25-percent rate, and, thus, ensuring the payment of some significant tax.

Let me turn to the effective date.

The CHAIRMAN. I will have to ask you to complete, please.

Mr. ZONANA. Well, as far as the effective dates are concerned, I will take 30 seconds.

As far as the effective dates are concerned, I think they ought to be pushed forward to 1987. I believe that the committee and the House and the committee should address itself to the effective date, but I am not that sanguine about the effective date on the excess passive loss insofar as sheltering preeffective date investments, if you will. I think you could have a phase-in rule as far as that is concerned.

Thank you for the opportunity to share my views with you.

The CHAIRMAN. Thank you.

We will take the other two witnesses, but I might announce to the members the order in which we will ask questions so they will be ready. We ask on a first-come, first-serve basis. The order will be: Senators Moynihan, Long, Bentsen, Packwood, Symms, and Danforth.

[The prepared written statement of Mr. Zonana follows:]

SENATE COMMITTEE ON FINANCE

HEARING ON ALTERNATIVE MINIMUM TAX PROPOSALS IN H.R. 3838

STATEMENT OF VICTOR ZONANA,
KAYE, SCHOLER, FIERMAN, HAYS & HANDLER
NEW YORK CITY

FEBRUARY 3, 1986

Mr. Chairman and members of the Committee: My name is Victor Zonana. I am a tax lawyer and a member of the law firm of Kaye, Scholer, Fierman, Hays & Handler in New York City. I am appearing here today by invitation of the Committee, for which I am sincerely grateful, and in my personal capacity. Over the past twenty years, I have been a practicing tax lawyer, a full-time member of the tax faculty at New York University School of Law, and Deputy Tax Legislative Counsel of the Department of the Treasury at the time that the Tax Reform Act of 1976 (H.R. 10612) was winding its way through the Senate phase of the legislative process.

In my remarks this morning, I should like to focus on but a few aspects of the alternative minimum tax proposals in H.R. 3838, the House-passed version of the Tax Reform Act of 1985. In particular, I will confine my remarks to the proposals applicable to individual taxpayers (rather than those applicable to corporations), and direct my attention to (1) the items of exclusion, deduction or credit which rise to the level of characterization as an item of tax preference, (2) the structural changes and the rate of the alternative minimum tax, and (3) the effective dates of the proposed changes. I do not propose to get into an extensive discussion of the technical issues in section 501 of H.R. 3838 at this time but will submit a separate set of comments to the Committee's staff members at a later date.

Role of Alternative Minimum Tax

As an initial matter, it is worth taking a brief moment to place the role of the alternative minimum tax in perspective. In some form or another, a minimum tax has adorned the Internal Revenue Code since 1969. Since its introduction, the minimum tax applicable to individual taxpayers has undergone numerous modifications and transformations. In its present form (last substantially modified by the Tax Equity and Fiscal Responsibility Act of 1982), the minimum tax is cast as an alternative minimum tax, applicable at a 20 percent rate, and comes into play if the alternative minimum tax exceeds the regular tax. According to a Joint Committee on Taxation staff report, in 1983 the mimimum tax accounted for revenues of approximately $2.0 billion derived from 235,600 individuals.

A generally widely-accepted justification for the existence of an alternative minimum tax regime is the concern that taxpayers with substantial economic income manage, through the perfectly legitimate use of exclusions, deductions and credits, to avoid significant tax liability. To meet that concern, the alternative minimum tax, in its present form, seeks to ensure that these taxpayers pay at least some minimum amount of tax.

A more appropriate and direct way of addressing the concern would be to examine de novo the necessity for the exclusions, deductions and credits which give rise to the phenomenon of little or no tax payable by individuals with substantial economic income. Eliminating the items or preference would lead to the elimination of the need for a minimum tax. Were it not practical to do so, and it is not, the minimum tax, as a policy matter, remains desirable not only for such reasons as maintaining public confidence in the integrity of the tax system but to ensure that some minimal amount of tax be paid by every taxpayer with substantial economic income. Even as our tax system undergoes substantial changes, it is quite evident that many of the preferences will continue to survive and that the minimum tax which has been a mainstay in the tax reform effort will continue to play a significant role in the development of a sounder tax system.

In evaluating the alternative minimum tax proposals in H.R. 3838, it is fair to inquire as to the extent to which the proposals are in harmony with the stated purpose and effect of the existing provisions of the alternative minimum tax. In my view, the H.R. 3838 proposals have changed the thrust of the alternative minimum tax very dramatically to the point of seemingly putting in place a parallel tax system designed to ensure, in the words of the House Committee on Ways and Means Report that, "no taxpayer with substantial economic income can avoid significant tax."[1] Further, the alternative minimum tax in H.R. 3838 was fashioned, we are told, to allow for a substantial reduction of the marginal tax rates applicable to high income taxpayers without "causing an overall percentage tax reduction of this group larger than for the average taxpayer."[2] How H.R. 3838 gets to that result and whether that is an appropriate approach is the focus of the remainder of this statement.

Items of Tax Preference -- Disallowance of "Excess Passive Activity Loss"

The House bill expands the list of items of tax preference and as a result broadens the base against which the alternative minimum tax applies. Broadening of the base is a desirable objective for it permits capturing economic income to a fuller extent, leads to more appropriate income measurement and hence a fairer tax levy. In this context, whether the minimum tax is designed to lead to "minimal" or "significant" taxes on substantial economic income is irrelevant.

Notably absent from the expanded list of items of tax preference is income exempt from tax under section 103 (state and local government bonds);[3] added to the list, however, is tax exempt interest on non-governmental obligations issued after December 31, 1985 (so-called "nonessential function bonds"). Also added as items of tax preference are excludable foreign sales company income and a portion of the untaxed appreciation relating to charitable contributions of appreciated property. Both additions seem perfectly acceptable and justified.

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[1] H.R. Rep. No. 99-426, 99th Cong., 1st Sess. 305-306 (1985) (emphasis added).

[2] Id. at 306.

[3] Cf. S. 956, 99th Cong., 1st Sess. § 2(c)(6) (1985).

Yet another new item is the somewhat peripatetic foreign-earned income exclusion under section 911 of the Code. Together with the item relating to incentive stock options (requiring inclusion of the bargain element at the time of exercise), these are the only tax preference items dealing with employer-provided benefits which are included in the alternative minimum tax base. While arguments can be advanced that other benefits (nontaxable fringe benefits, qualified plan employer contributions, salary reduction contributions under cash or deferred plans, and certain employer-provided health and welfare benefits) should be includable in the alternative minimum tax base, H.R. 3838 stops at the foreign-earned income exclusion, presumably in the theory that, unlike deferral items, the failure to recognize this item in the year in which earned means total forgiveness.

By far the most significant change in the computation of alternative minimum taxable income is the disallowance a taxpayer's "excess passive activity loss." This change undoubtedly will prove to be the most controversial. The principal overall impact can be described quite simply: For alternative minimum tax purposes, pass-through losses derived from investments in tax shelter limited partnerships will be allowed only to the extent of income generated from such investments, plus an amount equal to the lesser of "cash basis," and $50,000.

A simple illustration will be helpful: Assume that A, an individual otherwise fully occupied as a professional and earning a substantial income from that activity, invests $100,000 in shares of stock of a public corporation and $100,000 in a tax-oriented limited partnership. If the corporation were to suffer a net operating loss and the shares were to decline in value at the end of year 1, A would take into account neither the net operating loss nor the decline in value for purposes of computing his individual income tax liability. Absent subchapter S status, corporate losses do not pass through to shareholders. Moreover, realization and recognition of an economic decline in the value of stock in a corporation turns on disposition by sale or exchange, *i.e.*, when the taxpayer has severed his ownership of the stock.

On the other hand, under present law, a limited partner (who, by definition, is a passive investor) is entitled to claim on a current basis a share of what is in effect the net operating loss the partnership. Moreover, because of particular rules dealing with nonrecourse liabilities, a limited partner may be able to claim a share of "losses" which exceeds his investment in the partnership, all of this even though the value of his investment may not have declined at all during year. Thus, for example, if A's share of the "losses" at the end of year 1 is $150,000, he would be able to offset $150,000 of his earnings from his professional activity. Under H.R. 3838, the maximum amount of the loss that A would take into account in year 1 for purposes of the alternative minimum tax would be $50,000 even though his investment ("cash basis") in this activity is $100,000.

Just what does all of this mean? With some difficult technical questions yet to be resolved,[4] it means basically that for purposes of the alternative minimum tax the world is divided into two hemispheres -- in one hemisphere are tax shelter investments and in the other hemisphere are other investments, income and losses. Net losses in the tax shelter hemisphere can cross over the line and offset other income only when these losses are attributable to a disposition. Otherwise the losses remain suspended and are deferred until used up against tax shelter investment income.

The House Ways and Means Committee justifies its approach by analogizing an investment in a tax shelter to an investment in a corporation.[5] Whether or not we should accept fully the analogy is open to question. There are fundamental differences in the form of ownership (corporate or partnership) and in the tax consequences, alternative minimum tax considerations aside. In particular, there is a "double tax" in the case of corporations (tax on corporate income at the corporate level, tax at the shareholder level on distributions). What H.R. 3838 does in effect is to convert tax shelter limited partnerships into corporations for just one purpose -- curbing the pass-through of partnership losses which may have no bearing to actual current economic loss, or potential gain or loss on disposition. Whatever the rationale, there is considerable evidence that the principal culprit in the failure of the current alternative minimum tax to reach many high economic income taxpayers is the absence of a rule limiting losses from tax shelters to income from tax shelters. Given the goal of constructing a broad-based alternative minimum tax, the "excess passive activity loss "provision of H.R. 3838 is a desirable modification.

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[4] These questions include (a) the definition of an "activity," (b) the form of ownership (co-tenancies), (c) the definition of a disposition (should there be a special rule as to partial dispositions?), (d) applicability of the limitation to a general partner, active in the business, who is also a limited partner, etc.

Once one accepts the proposition that losses from tax shelters should be limited to income from tax shelters (except upon disposition), it is perfectly evident that, theoretically at least, neither the "cash basis" nor the $50,000 ceiling should have any bearing on the proper measurement of alternative taxable income for purposes of the alternative minimum tax, i.e., both are irrelevant. It is important that the Committee not be misguided into believing that the $50,000 ceiling should be increased to the cash basis level (if higher from $50,000) or that the $50,000 ceiling should be used even if cash basis is lower on grounds other than congressional largesse which would have the effect of sanctioning the limited use of tax shelters.

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[5] H.R. Rep. No. 99-426, supra note 1, at 306, 320-323.

Structure and Rates

H.R. 3838 alters the structure of the alternative minimum tax applicable to individuals in certain significant respects. In addition to continuing the present law system of permitting individual taxpayers to use the normative rules for computing certain preferential deductions (and thus avoid entry into the alternative minimum tax territory), H.R. 3838 introduces the concept of a "minimum tax credit."

The credit mechanism is designed to respond to the criticism that the alternative minimum tax opens the door to some form of double taxation, i.e., that the same item is taxed (or not recognized as a deduction) twice, once in the year the alternative minimum tax is imposed, and once again in a subsequent year for regular tax purposes. There is some legitimacy to the claim, in some cases. As devised, the credit mechanism is based solely on the deferral preferences, i.e., no portion of the minimum tax credit is generated by exclusion preferences. Once determined, the minimum tax credit is applied in subsequent years to reduce the regular tax but not below the amount which would equal the tentative minimum tax for that year. The credit application is not based on a tracing concept; the minimum tax generated by one deferral preference may be applied as a credit against any income, without regard to whether that income is attributable to the property (or activity) which generated the preference. Assuming the desirability of a credit mechanism in the first instance, this is an appropriate construct for it is both relatively simple and generally consistent with the rationale for such a credit -- the alternative minimum tax is some from of "down payment" of tax on account of the deferral preferences.

Another structural change is the recognition that certain deferral preferences (such as depreciation) give rise to adjustments in the alternative minimum tax base over a period of years. As a result, parallel depreciation schedules will be maintained. To the extent that the aggregate depreciation amount under the nonincentive schedule exceeds the amount under the incentive schedule, there is additional room created for other preferences.

A more fundamental change in the alternative minimum tax is reflected in the selection of the 25-percent rate. Under present law, the rate is 20 percent, compared with a maximum marginal rate of 50 percent. Under H.R. 3838, the 25-percent rate must be compared to the proposed maximum marginal rate of 38 percent. The revenue estimates indicate an increase in annual revenues between $4.2 and $5.1 billion. I have seen no estimate of the number of individual taxpayers affected, but I suspect it is much greater than the nearly 250,000 who were subject to the alternative minimum tax in 1983.

In assessing the propriety of the 25-percent rate, it is important to recognize that the thrust of the alternative minimum tax has changed (at least since 1982 and through H.R. 3838) to ensuring that significant taxes are paid by individuals with substantial economic income. The shift from "minimal" to "significant" satisfies the principal objective of a minimum tax (and it should be the overriding objective): meeting the perception that all taxpayers are bearing a fair share of the tax burden. A side benefit of that shift are the increased revenues. Whether 25-percent is the correct rate is not entirely clear to me. Intuitively, it suggests a great deal of complexity for many taxpayers who will spend considerable time with their advisers figuring out the point at which they have an "AMT problem." A lower rate (perhaps between 15 and 20 percent) on a much more simplified and expanded minimum income tax base may be preferable.

It is not simply the presence of two tax systems which is troublesome, it is the fact that the second system begins to approach the complexity of the first system. For instance, under H.R. 3838, separate pools of income and losses are created -- those dealing with incentive depreciation, those dealing with tax shelters, those dealing with farm shelters, those dealing with intangible drilling costs (under the bill only 65 percent of net oil and gas income may offset the preference). These pools overlap in some respects but not in others, necessitating considerable attention to determine the tax consequences of acquiring or disposing of an asset.

On balance, while I generally favor the direction of H.R. 3838 in terms of expanding the alternative minimum tax base, and the movement to a "significant" tax, I believe that a more coherent and less complex minimum tax structure can be devised to meet the fundamental objective of ensuring that all taxpayers pay their fair share of taxes.

Effective Dates

The alternative minimum tax proposals in H.R. 3838 would become effective for taxable years beginning after December 31, 1985. In general, with respect to many provisions in the House bill, I favor a January 1, 1987 effective date. There are too many transactions in which pricing and structure considerations turn in part on tax consequences. Transactions are being carried out today in a climate of uncertainty and many transactions are "on hold," pending clarification of the legislative outlook. This is particularly true in the case of many corporate transactions where the November 20, 1985 effective date for the repeal of the General Utilities rule seems unduly harsh. I do not believe this is healthy and would urge you to take a position on general effective dates in the very near future.

With respect to the alternative minimum tax, the effective dates selected seem quite reasonable (subject to the general comment above); that is, new items of preference are effective on a prospective basis only. The one troublesome effective date relates to the denial of the excess passive activity losses. As reflected in H.R. 3838, losses generated on account of investments in tax shelter partnerships made prior to the effective date of the bill will be subject to the new rules. The claim will be made that such an effect is unfair to those taxpayers who invested in tax shelters in reliance upon existing law. While the argument is not overwhelmingly appealing (the notion that one has contract with the government would suggest that even a lowering of the tax rates would result in an unfair denial of the benefit of the investment), a reasonable approach might be to phase in the limitation on losses over a period of three to five years.

Thank you for the opportunity of sharing my views with you.

STATEMENT OF JOHN W. HAMM, DIRECTOR OF TAX, ARTHUR YOUNG & CO., SAN JOSE, CA

The CHAIRMAN. Mr. Hamm.

Mr. HAMM. Thank you, Mr. Chairman.

My name is John Hamm. I am from the accounting firm of Arthur Young & Co. and the director of tax of our San Jose office.

It is indeed a pleasure to testify before you and to be back here in the Senate Finance Committee. As a former staffer, I sat behind you. It is nice to see your faces.

My testimony concerns the House-passed alternative minimum tax. Let me begin by relating an incident that occurred a couple of months ago when I was discussing with an individual client his tax situation. It appeared as if he was about to, as I phrased it, qualify for the alternative minimum tax. He smiled and said you mean there is an alternative to paying taxes. And I responded, no, there is an alternative to not paying taxes. And that is what the alternative minimum tax is.

This committee has taken a lot of flack about this tax. One commentator said that the minimum tax is an admission of failure on your behalf to cull out the tax preferences. Business Week a couple of weeks ago said: "If Congress really wants everybody to pay taxes, it should eliminate tax preferences altogether." Everyone agrees that the alternative minimum tax goes toward more complications than simplification.

Yet I contend that the alternative minimum tax is the right tax policy for you. It is the appropriate response for the tax policy dilemma, you find yourself in.

On the one hand, you want to use the Tax Code to influence economic and social behavior. It is the most effective way for Government to influence economic and social behavior.

And yet on the other hand, you want a fair, equitable, and just tax system where everyone carries their fair share of the tax burden.

The alternative minimum tax is an appropriate vehicle to accomplish both goals. You can still have the incentives and encourage economic behavior that is desirable and yet ensure that everyone pays a fair share.

It is not, however, part of that policy to make the alternative minimum tax the primary system. It should be the backup secondary system, a safety net, if you will, to pick up those that aren't bearing their fair share.

Where did all this start? It was 17 years ago last month in the Ways and Means Committee when the Assistant Secretary of the Treasury for the Johnson administration testified and shocked the audience that there were 155 Americans making more than $200,000 a year that did not pay any tax at all. Never has so much time, effort and anguish been given to making 155 nontaxpayers into taxpayers.

Every piece of tax legislation, since that time has contained modifications to this amount. Perhaps it would have been better to just assess those 155 taxpayers directly.

It is, however, an important goal. The country cannot afford a taxpayer revolt, and a taxpayer revolt surely will occur if people believe that there are people that are of means not carrying their fair weight in tax burden, whether he be an individual or a company.

The answer is not to eliminate the most effective means of influencing Government economic policy and repeal all the deductions, exclusions and credits, but rather to establish an alternative minimum tax to prevent the stacking, accumulation or stockpiling of tax preferences to the point of zeroing out your tax liability.

The House bill provides a unified alternative minimum tax for both individuals and corporations. It adds a number of new tax preferences. It increases the tax rate considerably. It greatly expands the alternative minimum scope to the point where maybe it is becoming the primary system, which is, of course, would be an overreaction and not the appropriate response.

It also revises the mechanics of the tax itself, and that is good. I would like to turn to that right now.

The House bill improves the AMT structure in two major respects: First of all, a number of the tax preferences contained in the alternative minimum tax are what accountants call timing differences, like accelerated depreciation. That is, the expenses give benefit over a period of years, but in the earlier years you accelerate that tax benefit. At the same time, you decrease the benefit or detriment in the later part of the life of the asset.

In the past, existing law has treated the tax preference as just the beneficial part. The House-passed bill nets the benefits of the early years against the detriments of the later years and only taxes as a tax preference your net benefit, if any, from accelerated depreciation, intangible drilling, expensing-type provisions.

This is very appropriate.

The House also recognizes that the AMT really, when it is properly structured, is nothing more than an advance on the payment of one's regular tax. You are paying a tax you would have paid later on. And the AMT is making you pay that now so that you ought to obtain a tax credit against your regular tax down the road when, in fact, you have to pay regular tax. And the amount of the credit should be the AMT that you previously paid. This, again, is what the House bill provides. I think it does, however, leave out some of the alternative minimum taxes as a future credit that are attributable to all other deductions such as the nonalternative minimum tax itemized deductions but this can and should be corrected by the committee.

Let me spend some moments on where I think the House-passed bill goes overboard. First of all, the excess passive activity losses tax preference just mentioned. This tax preference represents an overreaching by the House. It is almost out of frustration with tax shelters, that the House proposes this new tax preference. Certainly tax shelters present a major problem for this committee, and for the House Ways and Means Committee, to make sure that people feel like everybody is paying their fair share of the tax burden. But I submit that this particular provision is so littered with subjective determinations—What is a passive investment? Who is active in the management?—that it is going to cause endless arguments between taxpayers and agents, and add countless cases to the tax court's docket which is already overburdened.

All the rest of the tax preferences are pretty specific and objective in their determination. This particular one is, in my opinion, too subjective.

And I submit that it is also redundant. The other specifically defined tax preferences limited by this revised and strengthened AMT will substantially limit the effectiveness of tax shelters. You also have the at-risk provisions that limit excess losses. You also have the at-risk provisions that limit excess losses. You also have a series of penalties enacted a couple of years ago for abusive tax shelters. There is higher interest rate on tax shelter losses that are adjusted.

I think this represents overkill and will just serve to increase the argumentation between taxpayers and the Government. In fact, statistics show that tax shelters have started to recede over the past year.

And I think with lowering the tax rate, the maximum ordinary tax rate, you will see even further reductions.

In any event, even if you do decide to impose this subjective provision, it should only be with regard to passive investments that occur after the effective date. It should not penalize investments that are made prior.

Finally, I think the House overreacted by upping the tax rate from 20 to 25 percent. Think of where we have come from. When this first came in 1969, the alternative minimum tax was 10 percent, and the maximum regular tax rate was 70. We have brought the maximum tax has down to 50, and now proposed a 38 or 35 percent. And yet minimum tax has gone up from 10, to 15, to 20, and now talking about 25.

As Senator Bentsen indicated, this narrowing of the gap between the regular tax and the alternative minimum tax is a problem. The reason is that the alternative minimum tax is supposed to be the secondary tax—the safety net that catches people that are going too far with tax preference. The basics of an alternative minimum tax is a broad economic base and a low-tax rate. I think 25 percent is clearly too high. Fifteen to twenty is a much more reasonable figure.

A 25-percent tax also means that many taxpayers will find themselves in the alternative minimum tax, and will not forsee a time they won't be in it and thus can never make use of the minimum tax credit.

In conclusion, let me say the alternative minimum tax, is the appropriate vehicle for this committee to enact. It should be a broad-based economic concept. It should not rely upon subjective determinations like the excess passive activity rules. And it should have a tax rate, lower than 25 percent. Thank you.

The Chairman. Thank you.

[The prepared written statement of Mr. Hamm follows:]

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STATEMENT BY

JOHN W. HAMM

PARTNER, ARTHUR YOUNG
SAN JOSE, CALIFORNIA

COMMITTEE ON FINANCE
UNITED STATES SENATE

FEBRUARY 3, 1986

ALTERNATIVE MINIMUM TAX

My name is John W. Hamm. I am a Partner in Arthur Young and the Director of Taxes for our San Jose, California office. I am pleased to have this opportunity to testify before the Committee on the alternative minimum tax provisions of **H.R. 3838** .

Title V of H.R. 3838, as passed by the House, completes the opening scene of the third act of a three act drama begun over 17 years ago entitled "How to get all wealthy potential taxpayers to be actual taxpayers through a minimum tax." The opening scene of Act I took place in January, 1969 when the then Assistant Secretary of the Treasury for the outgoing Johnson Administration shocked the audience with the revelation that 154 Americans with adjusted gross incomes of over $200,000 or more had paid no tax at all during a recent year. From that moment to this moment, the tax writing committees as well as 5 separate administrations have attempted to make sure that rich Americans, whether individuals or corporations, paid at least a minimal level of tax on their economic income through an ever changing mechanism called the minimum tax.

The major conflict over the course of this long minimum tax drama has been between the Congressional desire to influence economic and social behavior through the tax code in the form of tax incentives (deductions, credits and exclusions) and the Congressional desire to have a fair, just and equitable tax code in which each American bears his or her fair share of the tax burden.

The basic philosophy of the minimum tax has always been, and continues to be, that each deduction, credit and exclusion in the tax law has a valid justification standing alone, but that taxpayers should be limited in their ability to collect, aggregate and stockpile these allowable deductions, credits and exclusions to the point of zeroing out their tax burden:

> "Whatever may be the merits of each of these tax preferences, of overriding importance is the principle that every individual with substantial income should pay a minimum tax toward the cost of government."
>
> 1969 Treasury Department Study, p. 13

> "The Committee believes that the minimum tax should serve one overriding objective: to insure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits. Although these provisions may provide incentives for worthy goals, they become counterproductive when taxpayers are allowed to use them to avoid virtually all tax liability."
>
> House Report 99-426 accompanying H.R. 3838,
> Tax Reform Act of 1985, p. 305-6

Act I in this drama consisted of the enactment of the original add-on minimum tax as part of the Tax Reform Act of 1969. During the debate preceding passage, a philosophical difference developed in the design and manner in which the minimum tax should operate which has continued throughout the last 17 years. On the one hand, some believed the minimum tax should be structured as a minimum level of tax on overall economic income (the concept of the alternative minimum tax):

> "...If one is already paying a lot of taxes, the minimum tax will not be an additional burden..."
>
> Senator Russell Long
> Congressional Record (December 12, 1969)
> p. S-16388

On the other hand, others believed the minimum tax should be structured as a minimum level of tax on any income sheltered by a tax preference (the concept of the add-on minimum tax):

> "Simply because a tax dodger is paying tax on some of his income is no excuse to allow his preference income to go scot-free of taxes... All taxpayers should pay at least some tax on their income tax loopholes... I am just as concerned with the individual who pays $100,000 in taxes and has $100,000 in tax-free income as I am in the individual who has no taxes and $100,000 in tax-free income."

Senator Ted Kennedy
Congressional Record (December 12, 1969)
p. 16373.

The resulting legislation in 1969 was a compromise between these two philosophies -- an add-on minimum tax but with a partial offset for regular taxes paid.

Act II of the drama began with the enactment of the Revenue Act of 1978 in which the alternative minimum tax was enacted for individuals along with an add-on minimum tax for both individuals and corporations:

> "Because the [add-on minimum] tax does not fully depend upon the amount of regular taxes paid by the individual, the present [add-on] minimum can result in a substantial tax increase for individuals already paying regular taxes at high rates."
>
> Senate Finance Committee Report 95-1263,
> page 201

Scene two of Act II saw the demise of the add-on minimum tax for individuals through the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 as well as the broadening of the alternative minimum tax base.

Act III drops the "other shoe" through the House passage of H.R. 3838 which repeals the add-on minimum tax altogether and provides an alternative minimum tax for all.

Tax Preferences For Individuals Under H.R. 3838

Existing alternative minimum tax preferences for individuals fall into four broad categories:

- o Timing or Front-end Deductions
- o Permanent Exclusions
- o Defacto Preference Credits
- o Defacto Preference Deductions

Timing or Front-end Deductions

These consist of expenses actually incurred in one year but which will provide economic benefits over a number of years. For regular tax purposes, the deduction for such expenses may be accelerated, that is, front-loaded rather than spread evenly over their useful life. Accelerated depreciation allows the cost of an asset to be deducted heavier in its earlier years and consequently lighter in its later years as compared to straight-line depreciation which spreads the expense evenly throughout the asset's economic life. Acceleration can be accomplished by either shortening the depreciable period from its actual useful life (ADR) or by increasing the rate of depreciation (double declining balance method) or by doing both (ACRS).

\ Present alternative tax law treats as a tax preference the accelerated depreciation of real property and certain leased property. The amount of the preference is computed separately for each asset and consists of depreciation claimed in excess of straight-line depreciation. The House bill continues old law treatment for pre-1986 acquired assets, but lengthens the straight-line measuring period for post-1985 acquired assets and extends the coverage of the preference to all personal property, not just leased personal property.

Present law allows for regular tax purposes certain expenses to be written off over a very short period or, in fact, entirely expensed in the year incurred even though these expenses may well have longer periods of economic benefit. The expenses include intangible drilling costs, mining and exploration expenses, circulation expenses and research and experimentation expenses. Present alternative minimum tax law treats as a tax preference the difference between straight-line amortization over a longer defined period and actual deductions claimed. The House bill continues old law treatment for such items with a few modifications (e.g., reducing the oil and gas income offset for IDC from 100% to 65%).

Nevertheless, the House bill greatly improves the existing AMT computation for timing preferences. The beneficial effect of accelerated deductions in the early life of an asset converts to a detriment during its later life. The House bill permits a netting of all such benefits and detriments for post-1985 acquired assets in arriving at the taxpayers net tax preference benefit, if any, for the year.

Clearly the most controversial addition to the timing tax preferences added by the House bill is the new preference for Excess Passive Activity Losses and Excess Farm Losses. The House bill assumes for purposes of alternative minimum tax that an investor in a non-corporate business should be treated as a shareholder in a corporation, and thus not benefit from losses derived by that business if the investor is either not active in its management or has no net cash invested in it (disregarding certain liabilities he or she may have with regard to their investment). This total disregard for the legal form of the enterprise even when the enterprise may not have any tax preferences or not qualify as a tax shelter represents an overreaction by the House to the admitted problem of timing tax preferences. It is clear the House does not propose deferring the income derived from such a passive investment as would occur to a individual shareholder in a corporation.

The provision is littered with a variety of subjective definitions such as "material participation" and "passive activity" that will result in never ending disagreements between the already overburdened Internal Revenue Service agents and taxpayers and will undoubtedly swell the Tax Court backlog beyond its limits. The rest of the alternative minimum tax structure which targets specific, identifiable tax preferences and the various penalties for abusive tax shelters contained in the Tax Code go a long way to insuring that tax sheltering will be held in check and wealthy Americans will pay their fair share of the tax burden without the introduction of such an overly broad, blunt instrument provided by the excess passive activity loss tax preference. Further, the provision, if enacted, has a major retroactive effect on individuals who may have made their investments in such activities years ago with no forewarning of any such treatment. In short, the provision should be dropped by the Senate Finance Committee and, if not, its impact should be limited to passive activity investments acquired after the enactment date. Similar transitional rules have historically been provided for other AMT preferences (e.g., depreciation, amortization and expensing provisions reference prospective acquisitions or expenditures).

Permanent Exclusion Preferences

The present law provides that certain permanent exclusions for regular tax such as the capital gain deduction and percentage depletion in excess of basis are treated as tax preference for purposes of the AMT. The list of permanent exclusions is expanded by the House bill to include interest on tax-exempt non-essential function municipal bonds, a portion of appreciated charitable contributions, and the exclusion for foreign-earned income. The impact of capital gain deduction preference is adjusted so that the maximum effective tax rate on capital gain does not exceed 22% under either the regular tax or the alternative minimum tax.

The tax policy here is, of course, to expand the taxable income base for the AMT to include all forms of economic income regardless of the incentive reason for providing an exclusion for regular tax purposes. Obviously, a side effect is to dilute the incentive effect overall. This is especially true for the exclusion for foreign income enacted and amended to provide an arbitrary exclusion to account for the relatively higher cost of living in some overseas locations vis a vis domestic work sites. The twenty-five percent alternative income tax may well cause U.S. citizens employed in high cost of living countries to suffer a major reduction in their present standard of living as compared to what they could enjoy in the U.S. This, in turn, will require U.S. employers to pay more to their overseas employees to equalize their standard of living with two ultimate results: first, less competitive pricing of U.S. companies' goods and services sold abroad and second, lower corporate taxes due to larger payroll costs. One wonders whether, on balance, the inclusion of this exclusion in the AMT will increase or decrease net government receipts.

The partial inclusion of certain tax-exempt interest may well foretell the eventual full inclusion of all tax-exempt interest. The Senate must decide the legal and constitutional arguments for or against taxing any municipal bond interest with the passage of this provision. The fact that not all municipal interest is being taxed or the fact that such interest is only subject to the alternative minimum tax and not the regular tax, provides no relief from the burden of deciding this legal and constitutional issue that has been the subject of extensive and emotional debate for over 70 years. If, however, you decide that the constitution does not limit the inclusion of interest on some municipal bonds in the alternative minimum tax base, it would be a short policy decision (not constitutional decision) to include all municipal bond interest in the tax base (obviously limited to post-enactment issues). This is not my recommendation, but merely my observation that it is hard to justify only the partial exclusion of municipal bond interest rather than the full exclusion or full inclusion of such interest.

Defacto Preference Credits

Existing law does not define any tax credit as a tax preference, but since most such credits can only reduce regular tax liability and not alternative minimum tax liability, they are defacto tax preferences. Taxpayers have often been shocked to learn that salary income, the standard deduction and investment tax credits can result in the imposition of alternative minimum tax in spite of the fact that they have no specifically identified tax preferences. Nevertheless, existing law provides that tax credits that are effectively rendered useless by the AMT be carried back or forward to offset regular tax liability, but not alternative tax liability in another year. The House bill continues this policy for individuals.

Defacto Preference Deductions

Existing law does not define any itemized deduction as a tax preference but since some itemized deductions such as state and local taxes, interest expense in excess of investment income, and miscellaneous deductions can only reduce regular tax liability and not alternative tax liability, these deductions are defacto tax preferences. It seems ironic that while Congress debates the deductibility of state and local taxes for regular tax purposes, some wealthy taxpayers have been effectively denied any tax benefit from such taxes for several years due to the alternative minimum tax. The House bill does not change these rules.

With regard to the deductibility of interest expense, it may be advisable in the interest of simplicity to consolidate the definitions of net investment income and net investment expense for purposes of both the alternative minimum tax itemized deductions and the regular tax limitation on the deductibility of investment interest under Section 163(d).

Minimum Tax Credit

The House provides further relief for timing tax preferences converting the alternative minimum tax attributable to such items as a credit against subsequent regular tax. This relief is appropriate since the AMT should be considered an "accelerated regular tax payment" on "accelerated, front-end deductions" and thus should offset regular tax payments otherwise due in the future.

It should be noted, however, that this relief is nearly worthless to an individual who expects to spend the forseeable future in the AMT.

The credit is also available for the AMT attributable to the incentive stock option tax preference recognizing that this preference is partly a timing preference (deferral of the income recognition from the date of exercise to the date of stock sale). Unfortunately, the year of sale may also be an AMT year and result in a double tax situation. The option profit is taxed once by the AMT at exercise and a second time at stock sale. It is suggested that with regard to this tax preference, the AMT tax credit be available against either the regular tax or alternative minimum tax in the year of stock sale.

I would also suggest that the minimum tax credit be available for alternative minimum tax liability attributable to defacto tax preference deductions such as state and local taxes, interest in excess of investment income and miscellaneous deductions. This would seem appropriate since the tax benefit for such expenses was only denied due to the existence of AMT in the year paid. The alternative minimum tax attributable to the denial of these deductions should be treated as a prepayment of regular taxes in a subsequent year when there is no alternative tax.

Corporate AMT Tax Preferences

The new corporte alternative minimum taxable income consists of the corporation's taxable income plus the tax preferences applicable to corporations reduced by a $40,000 exemption. The corporate tax preferences include all of the tax preferences of individuals except for:

- Research and experimentation
- Circulation expenditures
- Net capital gain deductions
- Incentive stock options
- Foreign-earned income exclusions
- Excess farm losses
- Excess passive activity losses
- Defacto tax preference itemized deductions

In addition, a tax preference only applicable to corporations is the reserve for losses on bad debts of financial institutions.

Most of the above-listed preferences are excluded for corporations because they are individual tax deductions and exclusions as opposed to corporate deductions and exclusions (e.g., capital gain deductions, incentive stock options, foreign-earned income exclusion, and defacto tax preference itemized deductions). Research and experimentation expenditures while deductible for both individuals and corporations, are only treated as tax preferences for individuals since they most often are found in tax shelter partnerships for individuals while such expenditures by corporations are an integral, necessary and desirable function of a corporate trade or business. In fact, the accounting profession requires that research and experimentation expenditures be expensed in the year incurred for proper financial accounting treatment.

Corporate Minimum Tax Credit

The House bill provides that all AMT paid by a corporation attributable to both permanent and timing preferences should be treated as a regular tax prepayment through the mechanism of a minimum tax credit. Nevertheless, the credit will be of little value to a company that will be in the AMT for the foreseeable future.

25% Tax Rate

The House bill raises the flat tax rate imposed upon alternative minimum taxable income from 20% to 25% for both indiviudals and corporations. Although this will undoubtedly raise more revenue, it is contrary to the central philosophy of a minimum tax -- broad income base, low tax rate. When the top rate differential is only 38% and 25% or 36% and 25% between the regular tax and AMT, the existence of two separate complicated taxing systems becomes less justifiable. The tax rate of 25% defeats the purpose of a minimum tax of extending a floor below the regular tax to catch the few Americans who fall below a reasonable threshold tax burden based upon a broad based income structure. When the maximum regular rate is 35% and 38%, the AMT at 25% will catch far more than a few. State taxes in high tax states could subject a large group of citizens from those states to AMT even without any tax shelters or other tax preference deductions, exclusions or credits.

With the AMT tax rate so high many capital intensive businesses will never get out of the AMT and as a result will never benefit from their minimum tax credits or their investment tax credit carryovers. This will essentialy subject "unwealthy" companies to AMT and require most companies to keep two sets of tax books during the year for estimate tax purposes. At the very least, it might be advisable to waive the estimated tax payment requirement for AMT so that companies would only have to compute AMT once a year after year-end. While it might be true that very wealthy individuals and corporations can afford to maintain the books and records and make the intricate computations required by the bill, this should not be imposed on moderate income citizens and companies.

STATEMENT OF DONALD SCHAPIRO, BARRETT, SMITH, SCHAPIRO, SIMON & ARMSTRONG, NEW YORK, N.Y.

The Chairman. Mr. Schapiro.

Mr. Schapiro. Mr. Chairman, distinguished members; my name is Donald Schapiro. I am a lawyer in New York. I am appearing here in my individual capacity. I am not representing, as you will see, any client or any organization.

I am honored by the invitation to attend and testify.

Five years ago in 1981 I appeared before this panel—was grateful for the opportunity to do so—in support of a provision or proposal that was then regarded as controversial, possibly revolutionary—the market-to-market system for taxing commodities tax straddles. But that provision was adopted, and it seems to be working fairly well. And I, today, will present another possibly controversial proposal regarding the individual minimum tax.

I think it merits your serious consideration. I would like to suggest to this committee that in lieu of the minimum tax approach adopted in H.R. 3838 they consider substituting, or at least using as an alternative—I would say substituting—the taxable income floor concept in the Moynihan-Chafee bill, S. 956. I think it would be far more effective than the present House bill. I think it would eliminate a lot of the problems that people are addressing themselves to, and I think it would be regarded as fair.

Essentially, the approach in S. 956 would substitute a schedular minimum tax in which certain types of income—net-earned income and net-investment income—would be plucked out and taxed at a minimum rate, unreduced by losses or deductions from other activities, irrespective of whether these other losses were real or not, abusive or not.

And where an individual was engaged in a capital-intensive business activity, which produced more income than earned income, the business income would be substituted in the minimum tax.

Under this suggested schedular minimum tax, itemized deductions allowable under the regular tax would be permitted. Net losses in personal service income would not offset net gains from investment income. Losses in investment income would not offset net-earned income.

There would, however, be carryovers and carrybacks in the separate income categories, and a generous exemption would be provided to eliminate application of the minimum tax to middle-income taxpayers.

This approach does away with adding back tax preferences. It just taxes specified kinds of income which everybody knows is income.

Now the question that is typically raised in opposition to a schedular tax of this kind is the question whether it is fair to tax more than economic income. Let me deal with that.

In other words, the question is whether it really is right to tax someone on their salary when they have a real loss, say, from running a drug store. My answer is that if I, as a lawyer, earn some money and have a capital loss on the sale of stock, I have no real economic income, and yet I certainly get taxed. And why does our tax system do that?

We do that because the revenues demand that we not allow certain kinds of deductions to offset certain kinds of income. Thus, there is nothing unusual or unknown in the tax laws to say that we are prepared to tax more than economic income for a good reason.

Now let me deal with the question whether or not it makes economic sense to tax more than economic income apart from the fact that there is precedent for so doing. Let me pose to you two cases of offsets to earned income.

Let's say all of the witnesses here on this panel are rendering personal services and we are making some money.

Now the first question is if the offset, which people earning personal service income are taking, is abusive; something you don't like, some kind of deduction you think isn't real. It certainly doesn't seem to be wrong to say in such a case that we are not going to allow that deduction against earned income.

Let me take another case. Supposing someone, a lawyer, doctor, investment banker, entrepreneuer, is earning income and offsetting that earned income with cases generated from a real other business activity? Say starting a magazine or some other start-up activity. These taxpayers are voluntarily decreasing their income. There is nothing written in the Internal Revenue Code or other tax policy which says that someone ought to be able to offset all their real earned income, or all their real investment income, with voluntarily incurred deductions for business activities they think are desirable, and which may build capital values in the future.

Let me put it to you this way, gentlemen: A secretary who has to pay Social Security tax has no way to avoid paying Social Security tax. Secretary and wage earners can't offset their social security tax by other deductions.

It seems to me that it makes a great deal of sense to say that those people who earn a lot more than the Social Security maximum ought not to be able wholly to offset their earned income with other deductions.

Under the suggested schedular tax, there would truly be no place to hide from tax. The provisions of H.R. 3838 would still permit taxpayers to wriggle out and zero down their income.

The schedular tax I propose would not permit this. It would be simple. All the concepts that we need to enact that tax are well understood. They are in the law already. In terms of personal service income, your committee will recall that some years ago we had a maximum tax rate for personal service income. The concepts of net personal service income are fairly well defined. As a matter of fact, you have to calculate net personal service income in order to do your own individual self-employment tax.

The concept of net investment income is also fairly well defined in the present code.

The alternative for personal service income where someone is engaged in a business activity—stockbroker or merchant, for example—directly or through a passthrough entity, would also, I think, be relatively easily defined and handled.

I suggest the Finance Committee think about this. I suggest you look at this without regard to rate for the moment. I am not discussing rate. I am talking concept.

Take the incredibly complicated individual minimum tax now embodied in H.R. 3838—we have heard about the proposed limitation of loss on passive activities and other items. I suggest we scrap this approach and instead tax what every human being in the United States knows is income: what you earn and what you get by way of dividends, interest and capital gains. That is not complicated. That will work. That will do the job.

In the corporate area, I think the arguments are quite different, and that the concepts in H.R. 3838 work reasonably well. I think this committee ought to try as best it can to define what real economic income is. That is a hard thing to do. I am not really sure that people agree on what economic income is. They know they ought to label it, and they know they want to catch it, but I am not sure they know what it is. Try to do it; put a rate on it.

In conclusion, I do urge that you consider taking the vastly complicated, very bulky, very difficult, individual minimum tax, getting rid of it, and taxing certain real income, pure, simple, direct. Thank you.

The CHAIRMAN. Thank you.

[The prepared written statement of Mr. Schapiro follows:]

COMMITTEE ON FINANCE - UNITED STATES SENATE

TESTIMONY OF DONALD SCHAPIRO

FEBRUARY 3, 1986

My name is Donald Schapiro. I am a partner in the law firm of Barrett Smith Schapiro Simon & Armstrong in New York. I have been engaged in law practice with that firm since 1952. I was a visiting lecturer in law at Yale Law School from 1947 through 1979. I appear here in my individual capacity and not on behalf of any client or organization. The views I express are purely my own today as they were in 1981 when I appeared before the tax writing committees of the Congress to urge adoption of the mark-to-market rules to deal with tax straddles in commodities futures. These proposals, which were enacted and seem to be working reasonably well, were regarded as controversial at the time. My recommendations to this Committee today may be equally controversial, but I believe they merit serious consideration.

Minimum Taxes: General Introduction. Minimum taxes are often labeled the stepchild of our tax system, and are criticized on the basis that they are a poor substitute for a fair and sensible tax. I, for one, do not agree with these criticisms.

In my view a minimum tax approach represents an effective way to mesh two important competing policies of our revenue laws. The first policy is that everyone ought to pay tax based upon their economic income. The competing policy is that our national economy benefits from subsidies provided through tax preferences for specific economic activities. The tax subsidies are effective to the extent they reduce tax burdens of persons who engaged in the desired economic activity. And yet, if these subsidies reduce someone's tax bill to zero, the policy that some tax must be paid on economic income is defeated.

It is no doubt true that limiting the ability of any single taxpayer, whether corporate or individual, to utilize legislatively mandated tax preferences to "zero out income" makes the tax preference less efficient, measured in a marketplace sense. This is true because more people will have to engage in the economically desired activity if the amount of the benefit which can be claimed by any single taxpayer is limited. And yet the policy that everyone pay some significant tax on economic income - that is, income calculated without reduction for tax preferences - must also be met.

In summary, H.R. 3838 substitutes an alternative minimum tax on corporations for the existing add-on minimum tax. This, it seems to me, is sound. In the case of individuals, H.R. 3838 retains the existing alternative minimum tax but adds a number of tax preferences.

I suggest to this Committee that for individuals, it would be appropriate to substitute the "taxable income floor" concept contained in the Moynihan-Chafee Bill (S. 956), which would be far more effective in the case of minimum tax for individuals. This Bill employs a "schedular" approach to the minimum tax in which certain types of income - net earned income and net investment income - are plucked out and taxed at a minimum tax rate unreduced by losses or deductions from other activities irrespective of whether or not these other losses are preferential.

Corporate Minimum Tax. The theory behind corporate minimum tax is that net "economic income" should bear a significant tax unreduced by "non-economic" losses. If we assume it is possible to identify the excess of "economic income" over taxable income computed under normal rules, the predicate for the corporate minimum tax is established. The policy basis is simple and clear. The alternative corporate minimum tax allows a limited amount of "non-economic" Congressionally sanctioned preferences to reduce taxable income. This follows the policy of requiring that tax preferences be spread among taxpayers.

If we adopt this approach, it seems to me that we must be true to our goals and accordingly measure "economic income" subject to the alternative minimum tax in the best and fairest way. Once we set about creating a tax system designed to measure "real" income, let us do it honestly, and let us not preserve any preferences at all in the minimum tax base. Reduce the rate of minimum tax if this is desired, but it seems to me economically unsound to preserve any vestige of non-economic deductions or credit in the corporate minimum tax base.

If this approach were to be followed, the Committee should inquire as to how broadly the economic tax base should truly be extended, and then define and tax it, possibly at a rate lower than that employed in H.R. 3838. Thus, H.R. 3838 should be culled to make certain that the corporate minimum tax base is as broad as "true economic income." I have no specific comments on how to define "true economic income" because net income is not a concept found in nature. Examining income reported for financial statements certainly is a good start.

Individual Minimum Tax. In the case of individual minimum taxes, I suggest that this Committee consider an approach which differs from H.R. 3838. Instead of seeking to tax "economic income" which involves a host of difficult problems, I suggest that the tax law adopt the policy set forth in the "taxable income floor" of S. 956 which singles out two classes of net income and subjects them to minimum tax. In other words, the minimum tax would break apart what is now a unitary concept of adjusted gross income, and apply the alternative minimum tax separately to two classes of income which are now combined with other items in calculating adjusted gross income.

This change is intended to reduce the adverse impact on the revenues which arises from allowing deductions stemming from unrelated or secondary activities to offset earned income and investment income (viz., tax sheltering).

A great deal of publicity has recently been given to tax shelter problems. Indeed, some of us may know of taxpayers who, in effect, are completely "sheltering" their income. I suggest this Committee consider a rule which does not attempt to single out "abusive" tax shelters as such, nor to attempt to determine what true total economic income is. The suggested concept is that individuals should be expected to pay significant taxes on their principal source of income, irrespective of other loss-producing activities they may engage in, no matter how "real" or "non-abusive" may be the items which give rise to the deductions offsetting their principal source of income.

I suggest that the individual minimum tax be imposed on an individual's income from personal services and investment income, not reduced by any other unrelated deductions which are taken into account in calculating adjusted gross income, except for alimony.

The minimum tax base would include the following two categories of income:

(a) The first inclusion in the tax base would be "personal service income," that is, earned income less applicable deductions.

(b) The second inclusion in the tax base would be net investment income from the following two sources: (i) gross income from interest, dividends and payments with respect to security loans and (ii) capital gains (net of capital losses) from the sale or other disposition of any item of intangible property and any item of tangible property which was actively traded.

The existing long-term capital gain deduction would be allowed in the calculation. Items would be included in the second category of minimum taxable income only to the extent that they were not derived from the conduct of a trade or business. Deductions against the second category would include deductions, attributable to such income, for interest, state and local property taxes, bad debts, amortizable bond premium, and expenses for production of income. No deductions would be allowed for depletion or depreciation, since income from items giving rise to depreciation and depletion are not included in the tax base.

In the case of pass-through entities, such as partnerships, "S" corporation, estates and trusts, items of personal service income, and investment income would pass through to the return of the individual.

Where an individual is engaged, himself or through a conduit entity, in a trade or business other than the rendition of personal services, the first category of personal service income would be replaced by a category of income consisting of gross income less deductions reflected in adjusted gross income from any single business activity, if such net income were larger than the personal service income of the particular taxpayer. This substitution is intended to cover cases in which, for example, an individual is engaged, either directly or through a conduit entity, in a business in which capital is a material income-producing factor (e.g., a merchant, dealer or manufacturer).

Under the suggested schedular minimum tax, itemized deductions allowable under regular tax would be allowed. However, no greater amounts would be allowed as deductions even though an expanded income base might allow greater deductions as in charitable contributions.

If there were a loss in the category of either personal service income (or the business activities substitute) or investment income, the loss in one category would not offset the other income for purposes of calculating the minimum tax. However, there would be loss carryovers and carrybacks in each separate income category for calculation of the suggested minimum tax in other years. Further, there would be generous exemptions provided to eliminate application of the minimum tax to middle income taxpayers.

The minimum tax proposal outlined above is contained as a "taxable income floor" in S. 956. I suggest this Committee consider substituting this "schedular" concept for the entire individual minimum tax. This would eliminate a huge amount of unneeded complexity and assure, beyond peradventure, that everyone who had large earned income or investment income paid significant tax. Truly, there would be no place to hide from tax. The provisions of H.R. 3838 would still permit taxpayers to wiggle out and zero down their income; the proposed schedular tax would close up all loopholes.

The theory behind the suggested schedular minimum tax for individuals is to assure that an individual with large amounts of personal service income, or investment income, would have to pay significant taxes. These individuals would be permitted to shelter their taxable income to the extent otherwise allowed by law but only up to, say, 50% of the tax that would otherwise be due on personal service income (or its business substitute) and investment income.

The validity of the suggested concept can be tested by making alternative assumptions as to the type of tax deductions a taxpayer is generating. For example, if the sheltering item offsetting earned and investment income is assumed to border on the "abusive," then it seems unobjectionable to say there should be a limit on a taxpayer's ability to shelter earned or investment income. On the other hand, if the shelter is clearly nonabusive - for example deductions paid in cash, or losses on a drugstore or other retail business entered into for profit -

the question raised is whether it is appropriate to limit the ability of a taxpayer to create future capital values at the expense of tax on earned or investment income. Our tax law has ceilings on deductions for pension plan payments and charitable contributions. Wage earners must pay social security tax on wages unreduced by deductions. By analogy, it does not seem unreasonable to limit deductions which build future capital values. Thus, a strong case, soundly based on reason, can be made for limiting the amount of offset which can be applied to personal service and investment income, irrespective of whether the deductions are deemed abusive, and even where the deductions represent "true economic losses."

The suggested rule differs from the provisions in H.R. 3838 which deal with denial of deductions from passive activities. I, for one, have difficulty in agreeing with the conclusions in the report of the Committee on Ways and Means of the House of Representatives that losses realized from a passive activity are "not truly realized by such individual prior to the disposition of his or her interest in the activity." Further, I believe that the policy contained in the denial of loss from excess passive activity losses would be met far more conveniently and effectively by taxing the two main branches of an individual's income, to wit, earned income and investment income, at a minimum tax rate.

I believe that a minimum tax for individuals would be more effective, more readily understood, simpler to administer, and perceived to be accomplishing its goal if all taxpayers had to pay some tax on their earned income and their investment income without regard to other activities they engaged in. I suggest that the test of "true economic income" is not appropriate in the case of individuals who reduce their "true economic income" from earnings or investments by voluntarily engaging in other activities which they regard as being economically desirable, presumably because of their ability to build future values, and which at the same time cut down current taxes.

A secretary or other employee must pay social security taxes on wages. I think that there should be a minimum tax on earned income above the Social Security limits. Further, I think the same type of minimum taxes ought to apply to dividends, interest and other investment income.

I appreciate the opportunity to appear before the Committee.

The **Chairman**. Senator Moynihan.

Senator **Moynihan**. Thank you, Mr. Schapiro. Mr. Chafee is not here, but I know he would appreciate your proposition, which is that the legislation that we have is direct and there is no hiding place. If you are earning money and you have got investment income, you are going to pay some tax.

I wondered if I could ask Mr. Abbin and Mr. Hamm, who would be involved with the audit process, you might say, in terms of making judgments under H.R. 3838, as to what is an excess passive activity loss. Would I be correct in hearing the two of you say that that is an awfully hard thing to do?

Mr. **Hamm**. That is an awfully hard thing to do.

Senator **Moynihan**. That is an awfully hard thing to do.

Mr. Abbin?

Mr. **Abbin**. Well, it not only is complex, it gets into a class distinction between those who invest in either limited partnerships or perhaps are not fully involved as a general partner and does have enough money to invest directly and have some management capabilities which no restriction whatsoever can zero out. So you are getting——

Senator **Moynihan**. Yes, yes.

Mr. **Abbin** [continuing]. Into complexity, but you are looking at the so-called very large investor—still—will perhaps be able to escape.

Senator **Moynihan**. You are saying that the larger your resources, the greater your resources, under H.R. 3838, the greater the likelihood that in fact you will escape paying taxes.

Mr. **Abbin**. It is more possible. I wouldn't say likely, but it is certainly much more possible.

Senator **Moynihan**. And Mr. Hamm seems to agree.

Mr. **Hamm**. Certainly in my practice I see a lot of tax issues. Most of them argue on points of law. This one is purely a factual issue, and as such cannot be easily resolved. And I don't think we need those sort of things littering our courts.

Senator **Moynihan**. You don't need those things littering the tax courts.

Were you passive, sort of passive, actively impassive?

Mr. **Hamm**. The House report itself, in fact, says it is a facts and circumstances question, they give some factors, but none of which are conclusive. I just don't think that it is an appropriate thing for IRS agents and tax advisors to be fooling around with.

Mr. **Abbin**. For example, if you owned a $10 million building or hired someone to do all the management, that is OK. But if you are one of a hundred that own that same building in a partnership form, and it is managed by the general partners, it is not alright. That is a distinction without a difference, in my mind.

Senator **Moynihan**. Mr. Chairman, I think we have heard some persuasive testimony on that point.

Could I just ask Mr. Schapiro and anyone else that would like to comment about how are we to deal with this problem of the gifts for charitable purposes of appreciated property? It is clear that not many people, not many individuals, are involved, but really important resources are involved. This is sort of the capital that makes its way to universities and research institutions. And those people who are responsible for these institutions really feel threatened. Not for themselves, but for the work of the institution involved. Is there any way around this, Mr. Schapiro?

Mr. SCHAPIRO. You know, you are not talking about what seems to me to be at the focus of really the tax policy problems that we are all addressed to. And that is, here is something that is viewed as desirable in the sense of promoting a socially desirable objective, on the one hand. And on the other hand, it produces a tax result which can be viewed as being aberrational in the sense that someone can, say, put a dollar into some stock, gone up in value to $50,000, be able to donate that and offset $50,000 of other income with that donation.

It seems to me that the solution to that problem, whether it is in the minimum or in the regular tax, has to be dependent on the rates and has to be dependent on the limits to which these kinds of deductions can be utilized. And like so many other things, I would think that if you have a minimum tax of 15 percent, as your bill has it, what you would be saying to these people who give that appreciated property away is that if you have earned income of $200,000 and you give away appreciated property with cost basis zero and worth $50,000, that you still have to pay a 15-percent tax.

Now I can't say right or wrong on that. But I think that you have got to look at it in the sense of how much revenue would be involved and possibly what the abuse would be involved in the thing. Perhaps you would limit the deductions of that kind to a certain percentage of income, and I think you would look very carefully to the rate of minimum tax.

Senator MOYNIHAN. We have a 30-percent limit now, don't we, in charitable contributions?

Mr. SCHAPIRO. Thank you very much.

Mr. ABBIN. Senator Moynihan, I might mention in response to that question about the charitable contributions you have an anomaly in H.R. 3838 that if you are terribly pure and have nothing but, say, salary and investment income, you can give your charitable contributions of appreciated property with impunity up to 30-percent limit; that when you get into other investment then you are scaled back dollar for dollar to the point that if you are a naughty taxpayer and invest in tax shelters and also give property away, you may get no deduction whatsoever. And, therefore, it will discourage charitable giving by other than those who are pure.

The CHAIRMAN. Senator Long.

Senator LONG. I am not sure I understood your proposal, Mr. Schapiro, but if I understood what you had in mind, you would charge the minimum tax to a person who in good faith went into business and lost money in the business even though what he lost in that year was more than his salary income. Suppose he went into business and he lost $100,000, and he had $90,000 of salary income. You would charge a minimum tax to him. Is that correct?

Mr. SCHAPIRO. That's just like I would, Senator. Let me explain the reason. The answer is yes and the reason is he was taking salary income and putting it into a business for the purpose of earning a profit. If he put it into the stock market and had a capital loss of the same amount, he would have to pay tax on his salary income.

And all we are saying here is someone who earns salary should not be free to avoid all taxes by voluntarily going into some other business activity presumably for sound purpose anymore than anyone can take capital losses if they want to.

But that is right. I mean that is the theme of it. You just can't reduce your income. And the secretary has to pay Social Security taxes notwithstanding that she loses money in the drug store. Now why is a secretary any more worthy of being taxed than anyone else?

Senator LONG. Well, we have situations in the law, right now—and the minimum tax is one of them—where a person can go broke—mind you, go broke—and still have the Government assessing a big tax on him. It amazes me when Senator Bentsen suggested that we ought to say that the minimum tax should be amended so it is not applied to someone who is broke, in bankruptcy. Why the devil should he pay a minimum tax under current law?

The whole concept of a minimum tax is that someone who made a lot of money ought to pay a tax. You would think that we ought to be able to draft the law well enough that where someone went flat broke, he wouldn't owe us an income tax. The estimate by Treasury was that if that Bentsen amendment became law, it would cost the Treasury about $300 million, I think. That's about a quarter of the money coming in for minimum tax, so 25 percent of the tax is from taxing poor souls that went broke.

The reason the matter came up was because Senator Grassley had a proposal to say that you wouldn't collect a minimum tax on a farmer who went broke. The thought was, ye gods, don't tell me we have passed a law where some poor farmer out there goes broke, working hard trying to make an honest living, and here we are trying to collect a minimum tax on him. And, bless Pat, we find out that in all kinds of business, folks are going broke and paying a minimum tax.

Apparently we are doing pretty good at that right now—collecting taxes on people who went broke. I would think we ought to be able to do a better job to zero in on the people that did make the money rather the ones who did not.

These people going into business are doing something we want them to do. They are trying to make some money legitimately and honestly. A lot of them are going into business without even trying avoid taxes. You know, people don't deliberately go broke in business. Very few do, do they? Is that a general tax avoidance scheme for people to go broke in order to claim tax deductions?

Mr. SCHAPIRO. Senator, I wouldn't put it that way. However, let me tell you the way it comes up as I see it. Someone has a lot of capital of tax-exempt income and they have some investment income and they decide to start a magazine. And there are a lot of deductions in a magazine, and you build up a lot of capital values. And now the question is what do you do with that sort of person and their investment income or their earned income.

And it just seems to me maybe you ought to start out and say if I am earning money, I have some investment income, got to put something aside for Uncle Sam, and I can only spend the rest.

Senator LONG. Well, I just don't happen to view people who are legitimately trying to make money and go broke doing it as being evil people. I think that they are decent folks doing the best they can, who are just very unfortunate. I don't see that we need the money so badly that we have got to go out and tax some poor soul that went broke honestly trying to make a profit.

Mr. **Schapiro**. We do it now for the capital gains and capital losses. And I think it is a question as to what policy you like.

Senator **Long**. Well, do you think that is right? A man went broke. If he could have, he would have stayed in business a while longer but the bank called his note and so he went broke. Do you think that is right?

Mr. **Schapiro**. Most of the cases where this happens, people have losses which would be deductible. It is an unusual case where someone gets taxed when they are broke. And you have to look into the facts and circumstances to find out why that happens because it doesn't normally happen. Our tax system normally doesn't allow that.

Senator **Long**. But it does. And I am asking you do you think that is right.

Mr. **Schapiro**. Let me put it this way. It depends on what the alternatives are. Whether or not you have to pick up some hard cases in order to make a general rule. The problem, Senator, basically is you really can't effectively distinguish whether people are "trying" to make money or people are trying to build values or what they are trying to do and you want to pay some tax.

The **Chairman**. Senator Bentsen.

Senator **Bentsen**. Well, Mr. Schapiro, I have been in some deals that didn't make money, but I usually didn't go in them with that intent. And I would say that it is very difficult for me to accept your argument. Suppose I have an income of $100,000 and then invest $100,000 into a limited partnership in a drug store and lose that amount of money that year. So, in effect, I am in a wash.

But then under your system I am going to turn around and pay a very substantial tax. That is difficult for me to understand frankly. I haven't reached that point.

I also want to comment on the reports we hear from time to time about certain numbers of Americans not paying tax. Treasury put out a statement last year that 30,000 wealthy Americans pay little or no tax. They basically used Mr. Schapiro's approach, as I understand it, because they looked only at the gross income side, but did not consider losses.

I really think that it is a disservice to the American people to leave those kind of illusions. I watched one of the networks that night make that their lead item. Once again, this is attacking the credibility of the American tax system. We have got a lot of problems with that.

And I recall my friend from Louisiana, too, trying to probe and find out who that tax evaders were so we could really nail them. But as you dug into it, you found that many of those people were paying taxes in foreign countries. They justifiably received a credit for that. In some cases, I believe they had some major casualty losses—a house burned down.

This idea of trying to grab a headline without having the facts clearly understood really concerns me. I want to nail those people too, but I want to be darn sure they are making money and not incurring offsetting losses or going into bankruptcy.

Let me ask you again. On the passive loss rule in the bill, can you justify going back retroactive on investments made in past years? I think, Mr. Abbin, you spoke to that point. And I don't know how you pronounce your name. Would you tell me, Mr. Zonana.

Mr. **Zonana**. Zonana.

Senator **Bentsen**. Zonana.

Mr. **Zonana**. Zonana.

Senator **Bentsen**. And I got the feeling you were somewhat troubled by that particular part of it, although you liked some of the other provisions of it.

Mr. **Zonana**. I am somewhat troubled by the effective date, although not entirely troubled by it.

Senator **Bentsen**. I got that.

Mr. **Zonana**. The reason for that is that it seems to me that this is very much akin to a rate change, for example. We are saying to taxpayers that we are going to lower the tax rate, let us assume—take that as an example—and taxpayers are going to say, well, wait a minute, I had entered into this deal about 4 years ago expecting writeoffs at the 50-percent rate, and if you lower the rate to 30 percent, you have cut out my return.

I am not entirely sure that the taxpayers have a contract with the Government as far as the losses are concerned and the rates at which they are going to be able to use them.

I can see some argument in terms of fairness and that people ought to be given some time to adjust.

Senator **Bentsen**. You ought to have something you can count on to some degree as you make an investment.

Mr. **Zonana**. That is true. And I do make that point earlier. I think there are some transactions that are now being considered and contemplated in the climate of a great deal of uncertainty.

Senator **Bentsen**. All right.

Mr. **Abbin**. Senator Bentsen, if I might. I am confused by your statement because one will accept that when a rate change takes place that the investment you have made, if they provide tax deductions, will give you a lower tax benefit. No one is discussing that point. Rather, they are saying if one made an investment in 1981 or 1982, be that real estate, oil and gas, and you now have the tax loss come through, you will accept a 38 or 35 percent top rate. We all acknowledge that.

Rather, the problem simply is should you be restricted to a total amount of $50,000 if your cash investment is $100,000 or $125,000. That is the question; not that we are complaining about getting a lower tax benefit. That is inherent in any tax change. And I think that is a rather different problem than what you are discussing.

Senator **Bentsen**. I can understand it on a prospective basis, and listening to your argument, I can find some justification for that. But I really have trouble going back on it.

Mr. **Zonana**. Let me just pursue that for one second. I really think that it is not a whole lot different than a rate change because what we are saying is we are not denying you the deductions that you had for purposes of computing the regular tax. We are simply saying, hey, there is a tax system out there that says you should be paying some taxes at certain rates. And you haven't been doing that. And the rate is now changing, and this, in effect, could be viewed as some rate change. I admit it is stretching a little bit, but I think you can view it that way to make sure that people do pay a fair share of taxes.

The **CHAIRMAN**. Let me pursue this then, the subject Senator Bentsen has opened.

We perpetuate. Change rates into Tax Code from time to time. Sometimes they go up, sometimes they go down. For some businesses, they are going up in this tax bill.

Is your position, Mr. Abbin, that all businesses that make investments or all individuals should be grandfathered at the rate or deductions at the time they invested then should not be affected by changes in the code that are perspective?

Mr. **ABBIN**. Absolutely not. I have absolutely nothing to say with regard to rate changes up and down. That is obviously in your province, and throughout history we have accepted the fact that rates were once 90 percent for individual; it went to 70, 50 and now perhaps will drop. And if you made an investment in the past, you are stuck with whatever tax benefit or detriment that incurs.

Rather, that when you have made an investment under a law in tact——

The **CHAIRMAN**. Under a what?

Mr. **ABBIN**. Under a law that is in existence at that point of time, that is, the code in effect in 1981, 1982, up through the current date, and you have committed yourself to an investment, and you expect to get your cost back as you make your investments, that, I think, is wrong then to say, no, you can't get all that cost back; you have to sit and wait.

To say that investment is only ascertainable as an income or loss when you dispose of it, frankly, I find that very convaluting to the reality.

The **CHAIRMAN**. Well then, let me pursue the original administration Treasury 2 bill where they had the recapture provision on the depreciation. Their argument being that you invested at one rate, and you expected that corporate rate to stay there, and now that we are going to lower the corporate rate, you are the unintended beneficiary of a windfall. And, therefore, we should be able to recapture part of that. The House didn't pass that, but that was the theory of the administration's bill.

What is wrong with the theory? If you made your investment in 1981 on that tax rate, assumed your depreciation, you are now going to get more than you thought you were going to get.

Mr. **ABBIN**. The biggest problem with that simply was the timing. They had a very arbitrary short period that had absolutely no correlation to the use of the life of their property. And had it been held to its normal useful life, it would have been 3, 5, 10 times as long.

The biggest problem with that simply is the matter of the timing of it. One could dispute the theory that an event like a change in law ought to require a total recapture would have been claimed over a 3-year period, and that was an inherent problem with that.

The CHAIRMAN. Well, I am still confused. Let me change the example.

You buy stock today. Assume the capital gains rate is 20 percent; you hold it. Five years from now we change the capital gains rate to 30 percent, you sell the stock. What rate of tax should you pay when you sell it?

Mr. ABBIN. Obviously, you will pay the 30 percent when you sell it.

The CHAIRMAN. Why? Isn't that a changing of the rules?

Mr. ABBIN. That's to change the rule, and that is your province. And that has happened up and down.

The CHAIRMAN. Changed to your detriment in this case.

Mr. ABBIN. Surely. And I have seen capital gains rates go as high as 49 and drop down to 20, and they have bounced around as you see fit to make it appropriate.

The CHAIRMAN. Well, the logic that I don't follow is if we change the capital gains rate to the detriment of the investor, why can't we change other rates to the detriment of the investor who may not have made the investment had she or he known what we were going to do subsequently.

Mr. ABBIN. I am not disputing that. You can change that. You can change the AMT as you have. My only point simply is should you change the ground rules of how much is deductible or it isn't deductible under the AMT system and it is under the ordinary system. It is not a matter of rates. It is rather—you have made the investment, you ought to be able to deduct it consistently under either system.

The CHAIRMAN. What difference does it make whether we change the deductions or change the rates? I fail to see the difference.

Mr. ABBIN. Conceptually, it is rather different.

The CHAIRMAN. Why?

Mr. ABBIN. Conceptually it is rather different, just as I think Senator Long quibbled with one of the other panelist on a schedular system. That isn't simply a change in rate. It is a change in the whole structure of this system, and that is what I am addressing myself to. Should you have a different amount that is deductible under something that is supposed to be a pickup to the regular tax system? What you are generating very simply is a completely separate tax system with separate rules about how much is the deductible, when it is deductible. And that I take a little offense to. It isn't rates. It is rather the amount. And that is not a rate change in my mind.

The CHAIRMAN. No, but we can reach the same end by changing the rate except to the extent you have no taxable income because of preferences. You are not bothered by changing of the rates which may lead to the same conclusion as the changing of the deductions.

Mr. ABBIN. Well, you could take anything and say that whatever it is only half of it is allowable for AMT. I wouldn't dispute that. I'm only saying that conceptually I am bothered that that does not make good tax policy.

The CHAIRMAN. Mr. Zonana, let me ask you a question about effective dates or any others who want to comment.

If we want to stop certain activity, and we don't want it accelerated during the pendency of the tax bill, how can we avoid it if we set a prospective effective date?

Mr. ZONANA. I am not sure that you can avoid it, Senator, but I do think that it is important at this stage of the game for taxpayers to know where they are headed. I do know that in my practice in particular—and I know in the practice of others—tax planning has become—for years has been a very difficult exercise. It is now even more difficult with the uncertainty in front of us of what the effective dates are likely to be.

And, in particular, some of the November 1985 dates, such as the one on general utilities, which I think is the most troublesome with respect to a number of transactions that are now ongoing.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. Suppose the House bill were to be enacted and a client came in to you and said I have assets of half a million dollars and I would like to avoid paying any taxes at all. Could you help that client realize his wish?

Mr. HAMM. Yes, sir.

Senator DANFORTH. How?

Mr. HAMM. You tell him to invest in tax-exempt bonds.

The CHAIRMAN. I couldn't hear your answer.

Mr. HAMM. Tell him to invest in tax-exempt bonds.

Senator DANFORTH. If H.R. 3838 were to be enacted, then the value of tax-exempt bonds to taxpayers would be all the greater, wouldn't it? I mean it would funnel the demand for avoiding taxes toward tax-exempt bonds.

Mr. HAMM. I think that is true.

Senator DANFORTH. What would be the effect of H.R. 3838 on charitable givings? Senator Moynihan raised the question, but I don't think he elicited a response from you. Would it have a catastrophic effect on charitable contributions if untaxed gains on appreciated property were added back?

Mr. HAMM. It would have some effect. Probably the biggest effect is just lowering of the tax rate will have an effect on charitable giving itself. The untaxed part of capital assets, that will have an effect on charitable giving, but I think there will be a distinction on which charities suffer. Typically, universities will probably be the biggest losers since other charities oftentimes receive cash contributions.

Mr. ABBIN. I think it will affect it, Senator, in the note I expressed before. That if someone, for example, has a capital gain, that would be a bad year to make a contribution in kind of appreciated assets because every dollar of the capital gain exclusion would offset a dollar appreciated charitable contribution.

Likewise, if they had other amounts that are considered preference items under the long list in 3838, that would also discourage anyone from making a charitable contribution in that year.

So at a minimum, it would affect the timing. One would have to better plan, if that is at all possible, not to have preferences the year you are asked to make a charitable contribution of size of appreciated property. There comes a point, of course, where you can balance them off and still not be hurt, but it would take a great deal of tax planning. And perhaps the panel here would be more employed than we have in the past, but I am not sure that is an appropriate answer as to why that ought to be so.

In other words, it is going to take a great deal more effort by those making contributions in kind or asked to do so with this odd way of handling it that if you are completely an income earner or a passive investor you can give charitable contributions that are appreciated with impunity, but once you get off into generating preferences, you lose dollar for dollar and there comes a point where it isn't at all effective from a tax planning point if you are ever to make more contributions.

Senator DANFORTH. Well, have there been any studies as to the effect of this bill on charitable contributions? Or is this just the surmise?

Mr. ABBIN. I think it is more surmise than any empirical evidence at this point in time.

Senator MOYNIHAN. Could I interrupt? Professor Larry Lindsay an economist at Harvard has done some studies. I mean a big study.

Senator DANFORTH. Do you think that the R&D credit should be added back for the purpose of the corporate minimum tax?

Mr. HAMM. I don't. I think the R&D—the R&D expense, you mean, added back to the alternative minimum tax?

Senator DANFORTH. Yes.

Mr. HAMM. I don't because I think that is much more of a 1-year writeoff activity anyway. The accounting profession feels that it should not—it doesn't have a useful life. I think a statistic that I saw was 88 percent of R&D money ultimately is, in effect, a dry hole. So it is hard to trace where that money would ultimately have use outside the period.

It strikes me that from the corporate side it is an integral part of a business's activity.

Senator DANFORTH. How about the rest of you? Do you have a view on that?

Mr. ABBIN. Senator, I think the word used, credit, ought to be focused on again. And that is, that start-up emerging companies who are generating these credits as they build up their businesses will be deprived to offset their AMI by this credit. I think that this is a very strong discouragement to start up and emerging high tech companies as contrasted to larger companies who do not ever have that limitation come into play.

And there are two aspects. The House took care of the preference for R&D deductions, but the creditability is still not there either from carryovers or currently incurred R&D credits. And I find that still to be a problem for the smaller emerging companies.

Mr. SCHAPIRO. Senator Danforth, I think my views in that matter would be influenced in part by what the financial accounting treatment of the R&D deductions are since the attempt to determine what is economic income as we know is a very difficult job. And it would seem to me that in concept if it is generally accepted that R&D ought to be capitalized and not deducted for financial accounting, then it seems to me a lot of thought has to be given to following the same rule in the corporate minimum tax. If the concept is that the corporate minimum tax will be a tax of however high the rate is or however low the rate is on true economic income.

And I think the approach to the question of what should be deductible under the corporate minimum tax ought not to be a sound social policy or desirable economic policy to allow these deductions but in the search as best we can make it for true economic income how is it regarded most intelligently. And then I think we ought to set the minimum tax rate, corporate minimum; tax, at whatever rate is desired to just produce a minimum tax on, you know, economic income.

The **CHAIRMAN**. Senator Durenberger.

Senator **DURENBERGER**. Mr. Hamm, let me ask you to clarify your response to the question that Senator Danforth proposed regarding the preferences for tax exempt bonds. I had the impression that in H.R. 3838, which I haven't yet read, they included nonessential function bonds in the alternative minimum tax. What is the impact of that inclusion in your opinion?

Mr. **HAMM**. Well——

Senator **DURENBERGER**. Or do you want to reclarify your response?

Mr. **HAMM**. Well, I think that is true. General obligation municipal bonds are not included in the alternative minimum tax. Nonessential function bond interest is included in the minimum tax. Therefore, I would direct my client to buy general obligation revenue bonds.

Senator **DURENBERGER**. There are no revenue bonds, mortgage revenue bonds, that would be included in there? There would be no IDB or IRB bonds that would be included—I mean would be outside the nonessential function bond category?

Mr. **HAMM**. I believe there is a cap as to how much a State can issue, and in excess of that cap those would be nonessential.

Senator **DURENBERGER**. I understand that.

Mr. **HAMM**. I believe that's how that would be treated.

Senator **DURENBERGER**. Let me ask any of you a question with regard to the investment credit offset problem.

Might it be possible to resolve that problem if companies amortized their investment credit carryovers and were then permitted to use a portion of their credits to offset minimum tax liability? To what extent, for example, would the value of these carryovers be diminished under an approach that permitted taxpayers to use, say, one-fifth of their credit carryovers each year?

Mr. **ABBIN**. In general, that certainly is a significant improvement, Senator, over what is proposed now. You have the anomaly that if you had losses in 2 out of 3 years you are able to take your credits, but no one else can use those credits. Whether 5 years is reasonable or not, I think many would certainly appreciate that compared to how—no capability of using the credit ever simply because if once they get on this high rate AMT cycle they may never get off, and, therefore, the credits by their life time definition will expire. And getting something over 5 years is obviously better for those companies who otherwise would get nothing, period.

So as a generality, yes, I think that is quite more acceptable than what we have right now.

Mr. HAMM. I would tend to agree. I think that is a very good suggestion. Some kind of an amortization against the alternative minimum tax.

Mr. ABBIN. Another approach, of course, Senator, would be to scale the ITC's to some proportion of the AMT just as you have the general business credit being only to the extent now of 75 percent of the basic tax. Whatever that formula is, obviously, is the decision for you to make. We can suggest a lot of things, but it gets down to how low you want the AMT to be after credits, and I think that is much more of a political process of what is appropriate than it is for us technicians to tell you.

Senator DURENBERGER. Let me also ask all of you the question—Murray Weidenbaum said last week the $24 or $25 billion that was anticipated to be raised from the minimum taxes is wildly inflated. And I think we started to get at this issue of tax planning a little bit ago.

It seems to me it does place a premium on tax planning. To what degree do you think taxpayers are going to simply adjust their investment decisions to whatever alternative minimums we come up with, and, thus, really minimize the amount of money that we expect to recover from this?

Mr. ABBIN. Well, Senator, obviously, human behavior response to the changes of any kind, especially the Tax Code, certainly to some extent that will take place. But, of course, for egregious or abusive tax shelters that you all have focused on, that is what you want to have happen anyway. So that is just a natural function.

To the extent you get into corporate environment, I don't know how you want to account for this, but I suggested earlier that there is 30 billion of ITC carryovers, a high proportion of which will never be available to be used to the companies that get on an AMT cycle forever. So how do you account for that? Is that something under prior budgets, current legislation, et cetera? There will be adjustments in behavior.

Many, however, will not be able in a business context to adjust themselves out of the system. The individuals, yes, but that is behavior you want to adjust anyway.

Senator DURENBERGER. All right.

Mr. SCHAPIRO. Senator Durenberger, I think in the H.R. 3838 individual tax I wouldn't at all be surprised if a lot of people find ways to wriggle out. And I would expect they will, and indeed they should because that is what Holmes said. There is nothing wrong with planning your taxes.

But I point out that if they go for the Moynihan-Chafee approach, you can't do that. There is just no way to wriggle out then. You have got to pay the taxes. If you just take all the earned income, all the investment income and there it sits and you put the tax on it, there is just no wriggle. And that will catch people at tax rates.

Now I don't know the rate you want to put on that, but I will tell you that I think you will keep people on the tax rolls to a far greater extent.

On the corporate minimum tax, if you go about it in a serious fashion and pick up all true economic income, and I would say that would not permit amortization of investment credits. I mean just pick up all true economic income. Once again, there will be little planning.

It really depends how serious the Congress is about having everyone pay some tax. Easy to do it if it is done seriously.

Mr. **Hamm**. Senator, there is an interesting effect that may happen in tax planning in this regard in that when a taxpayer finds himself in a minimum tax, the best strategy is to accelerate income into that year so as to take what would otherwise be a 50-percent dollar next year and bring it into current year 20-percent tax. That is a standard alternative minimum tax strategy.

That has the effect of accelerating Government revenues, although in the long run the present value of tax revenues will be less.

Mr. **Abbin**. Just a response on the individual side, Senator Durenberger. I think there will be some change in behavior. I think all taxpayers think it is their God-given right to lower their taxes, and that is perfectly acceptable as far as I am concerned.

I also think that the measurement of revenues is somewhat difficult. And I am not entirely sure that you can really capture and say that there will be $4 or $5 billion raised through the alternative minimum tax. I do believe that we would be making progress even if the alternative minimum tax is revenue neutral because the effect will have been to shift taxpayers onto the regular system, which is what we are trying to do here.

The **Chairman**. Senator Bradley.

Senator **Bradley**. Thank you very much, Mr. Chairman.

We are considering the overall issue of tax reform. In the House bill there is a minimum tax with a very broad base, which means that it sweeps in a lot of preferences. And it has a 25-percent tax rate.

Now if you cut that tax rate on the alternative minimum tax embodied in the House bill from 25 to 20 or to 15 percent and do not broaden the base of the regular tax further, wouldn't the result be to allow the wealthy to pay less tax and as a proportion of the total and to increase the tax on the middle income taxpayer?

Mr. **Zonana**. It is possible. But what I am not entirely sure, Senator Bradley, is where that point occurs in terms of the rate.

Senator **Bradley**. You mean at what income level?

Mr. **Zonana**. Is it 20-percent rate? It is a combination of both the rate and the level at which you are going to break that income. And I am not entirely sure whether a 25-percent rate with a $40,000 exemption as is in H.R. 3838 with an expanded base is, in effect, saying that we now have all taxpayers with economic income over $150,000 in the AMT.

I have not seen the studies. I have not seen any published at least, anyway, that indicate how many taxpayers will be affected and at what point that break point will occur.

It seems to me that it is a guessing exercise. What you should try to do, I think, is to calibrate the rate at a point where the rate and the break point at a point where some taxes are being paid. You then have to decide whether those are to be minimal taxes, significant taxes; what level of tax you want them to pay. That is the way I would approach it.

Mr. **Abbin**. Senator Bradley, I perceive this as being an approach to get at a few, be they companies that have been listed very often by certain research groups picked up by Congress, et cetera, or individuals, at the very high end of the scale. And in the process of attempting to get at those nontaxpayers, I suggest you will have significant overkill for lower middle income and middle income being whatever one wants to define it, but certainly not the super rich.

Very simply, under H.R. 3838, a very wealthy individual who can put up a half or a million dollars a year has absolutely no problems avoiding the impact of that AMT.

Senator **Bradley**. Why?

Mr. **Abbin**. Simply because you can get around it through the nature in which you invest. You take more risks, and when you are wealthy enough you can take the risk with the same consideration of doing away with the at-risk aspect of real estate investment. The truly wealthy don't worry about that. They are at risk anyway, so they don't worry about nonrecourse debt.

When you get into putting up your own money, your being at recourse, you can get completely around what this law is all about simply because you put up enough cash, you will not have this passive loss come in whatsoever. You won't even be limited as a so-called passive investor.

Therefore, what I am suggesting is that with a very high-rate, broad-base that we see in H.R. 3838, for the individuals it is the upper medium executive individual who is going to get hurt badly. The super wealthy will not. And the same is true in companies. The small emerging startup companies will be hurt much more so than——

Senator **Bradley**. I would like, if I could, to shift to another question in my available time.

Would not a minimum tax have widely different effects on the corporate side depending on whether a firm was a freestanding firm that now pays very little tax or whether a firm is a conglomerate that is able to offset its high tax in one division by the very low tax in another division? In other words—and I think you have testified to this in your statement, Mr. Abbin—you said the minimum tax might encourage more business combinations through mergers and acquisitions.

Now do you mean by that that the food company that has an effective tax rate of 42 percent would be very likely to acquire a company that has very sizable writeoffs through various of the tax expenditures because the combination would allow avoidance of the minimum tax?

Mr. **Abbin**. That certainly is one possible result. Or research firms, for example, that get into biotech aspects of food preservation it would be beneficial.

Senator **Bradley**. I would like to go down the panel and have each of you say what you think the effect of a corporate minimum tax, as it is now written, would be in terms of increased concentration, increased mergers, and acquisition.

Mr. Schapiro.

Mr. **Schapiro**. Well, it certainly might because really we are setting up a system now in which essentially people who paid no taxes under the current system would have to begin to pay taxes. And if they combined with businesses that were paying taxes, you would meet the minimum. I think it might well. But that really doesn't give the answer as to whether it is a good or bad idea. I mean it is just the impact of a corporate minimum tax.

Mr. **HAMM**. I think it might be the other way around. I think that acquisitions, and concentrations, are there now and to a great extent encouraged by the desire to net a zero tax and a 46-percent tax. But, in effect, having narrowed that gap in the House bill, you have reduced the desire to concentrate.

Senator **BRADLEY**. By lowering the rate, you mean?

Mr. **HAMM**. By lowering the rate differential.

Senator **BRADLEY**. Mr. Zonana.

Mr. **ZONANA**. I don't know where it is going to come out. I have no idea.

Senator **BRADLEY**. And you, Mr. Abbin?

Mr. **ABBIN**. I still would repeat what I wrote before, consistency and also because I believe in it; that it will encourage simply because the break point at 36 or 32 or whatever percentage Congress ends up with still will provide a great deal of capability of those who have the sheltering aspects of a higher rate to provide encouragement to those who either can't use the incentives, be they deductions or credits. And when you look at economics, there comes a quick break point where it is attractive to get together and have a marriage rather than going your separate ways.

Senator **BRADLEY**. So you say yes it will lead to greater concentration?

Mr. **ABBIN**. Yes, definitely.

The **CHAIRMAN**. Senator Boren.

Senator **BOREN**. Let me go back to the point that you were making just 1 minute ago in which you said the way the bill is now written that it could put an undue burden on middle-income people or upper middle income people and yet still allow some, the very wealthy, to escape its effects altogether.

Let me go back to that and ask you how you would fix that so that that would not—so at both ends so that you would not allow people to completely escape and also so that you would not put that undue burden on a broader group than is intended.

Mr. **ABBIN**. The best fix unfortunately is the one that seems unavailable and that is to do it to the basic income Tax Code because I think it is very inefficient, very arbitrary, and in all probability, none of us, either on this side or your side, are bright enough, omniscient enough, to generate a system that will catch everybody you want to catch and yet not hurt people unintentionally.

I think there are inherent traps in any dual track system like this AMT is. No matter what you do to catch the people at the top, you are going to hurt some people along the way.

Mr. **SCHAPIRO**. Senator Boren, I would like to suggest the thought that I think the Moynihan-Chafee bill would solve the problem. No one of high income would escape if you tax investment income and earned income, alternative business income. And I don't think it would have any impact at all on the middle-income people whatsoever with the exemptions.

Now that would do that job in the individual, in my judgment. And it is not complicated. It may have the disadvantage that Senator Bentsen and Senator Long pointed out in some cases of taxing people who have no net economic income, but we do that anyway with capital losses.

If you want to accomplish the objective that you wish to accomplish or you have stated of catching everybody and not hurting the middle-income people, the schedular tax would do that job very well indeed.

Mr. ABBIN. My rejoinder, Senator Boren, would be do we throw the baby out with the bath water. In the schedular tax, yes, you will catch everybody, but what do you do to the entrepreneurial motivation. And I think Senator Long went to some great extent to point out that if you are going to take all risk capital and say it only gets deducted if and when you make money at the end, I suggest that is a rather severe economic impact just to catch some people not paying AMT.

Mr. SCHAPIRO. I don't think it does that. All it says is you can't deduct it against all your income. If I am paying taxes now at 50 percent, I can spend a lot of my income on entrepreneurial activities and bring it down to 15 percent. I just can't spend it all. That is all.

Mr. ABBIN. The question is do we stop at 15. I mean we are dealing with 25 today, sir.

Senator BOREN. Several of us have suggested in terms of the corporate minimum tax that we have brackets, in essence, of different rates of different brackets. Some, the breaking point starts at 15 percent; it changes at $1 million and so on up to 25 percent. From a technical point of view, setting aside the policy questions, does that cause us any difficulty in terms of raising it that way?

Mr. HAMM. I don't think it causes you any difficulty. It is a little bit more complex, but a rate schedule isn't that much more——

Senator BOREN. You still see it as workable?

Mr. HAMM. I think it is still workable. And it addresses your question as to taking the lower income corporations off the high-tax rate.

Senator BOREN. Could the panel discuss the difference between the concept of an add-on minimum tax and an alternative minimum tax and perhaps make some comments about the general desirability of the two approaches?

Mr. HAMM. Well, we started with an add-on minimum tax 17 years ago and we have evolved into an alternative. And it involves a philosophical difference. It started in 1969, as a matter of fact.

An add-on minimum tax taxes income being sheltered by tax shelters, by preferences, without regard to what taxes you are paying on nonsheltered income. In my testimony is a statement by Senator Kennedy made in 1969 in which he said he was just as concerned about the tax-dodger that has $100,000 of tax-exempt income and is also paying $100,000 in tax as he was with the tax-dodger that pays no tax on $100,000 of income. He was just trying to get at the exempt income.

Whereas, the alternative minimum tax is a minimum level of tax on all economic income.

Senator BOREN. So with the add on you are really directly reducing the—whatever advantage there is, whether we call it an incentive?

Mr. HAMM. Correct.

Senator BOREN. You are reducing the effect of that particular incentive that has been placed in the code regardless of how much income tax the individual is paying otherwise?

Mr. HAMM. Correct.

Senator BOREN. Whereas the alternative really is aimed at the concept that—or you might not want to undo the incentives that everyone who has benefits should contribute something back, some minimum amount, back to the system.

Mr. HAMM. You can't stockpile all the credits, deductions and exclusions to the point of zeroing out your income tax.

Senator BOREN. Do I gather that conceptually all of you lean toward favoring the alternative minimum tax as opposed to the add-on tax?

Mr. ZONANA. I definitely would favor the alternative minimum tax as opposed to the add-on minimum tax. The add-on minimum tax is really going to the specific preference in isolation and saying we don't like you to use 15 percent of it. I think it really turns out to be, in the experience at Treasury and the data demonstated, that it really was nothing more than a slap on the wrist. And that is why the move came to go toward the alternative minimum tax in 1973 first, but finally in 1978.

Mr. SCHAPIRO. I would certainly agree with the alternative minimum tax as a better approach.

Senator BOREN. Thank you very much, Mr. Chairman.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Mr. Chairman, we have heard some awfully good testimony and we are a lot further in our understanding of both the House bill, which isn't easy—how did you fellows manage to read that thing? It is 1,300 pages.

Mr. ZONANA. We have a lot of associates. [Laughter.]

Senator MOYNIHAN. Senator Danforth raised this question of the gift of appreciated property to charitable institutions. And he asked if there were any numbers involved that had been put together. And Larry Lindsay, working for the—maybe the National Bureau of Economic Research. He has broke this down, and, Mr. Chairman, I would like to put it in the record, if I can.

The CHAIRMAN. Without objection.

[The information from Senator Moynihan follows:]

Senator MOYNIHAN. And under current law to prohibit this would reduce gifts by about $1.1 billion from the $2.5 billion that is now the case. And under the House bill, he makes the $570 million from a little less than $2 billion. A very large loss to enterprises.

We understand it as it is explained to us that this is sort of the capital resources of private educational medical institutions; some others, museums as well. It really poses—I mean, you know, there are thoroughly responsible men and women who come to see you and say this is putting in jeopardy one of the most important institutions of this kind. A fellow named Bradamus came to see me about a place called NYU and knowing whereof he speaks.

Does the panel have any thought on that?

Mr. **Abbin**. Senator Moynihan, I think you have to make really the decision as to whether the Government wants to indirectly support these institutions through a tax subsidy. And, if so, I would suggest that it is inappropriate to have appreciated property, charitable contributions, be included in the listing of tax preferences because you get this anomaly, as I mentioned a couple of times before, that those who might be giving but also dealing in other activities, even selling stock, would find no benefit, and, therefore, they are going to scale back. Now how much of the contribution motivation is changed through decline in the brackets is a very subjective thing. But I would suggest that also has its impact. It is irony that as you lower brackets and that is better for the income levels, it does change people's minds about giving.

But, nevertheless, you do have this difficult decision that most of the incoming property contributions are made by the wealthier people. And that is probably perceived as somewhat as an escape hatch if you can get the deduction but you never pay tax on the appreciation. It still is a terribly significant source of funding for universities, hospitals, art institutes, et cetera. So I think you have this tremendous dilemma of how you want to help finance that or how far do you want to go to discourage that financing through the Tax Code.

Senator **Moynihan**. Could I ask the panel, anyone who might have a view—Mr. Zonana has talked about tax planning—in the Treasury's—when they first put this forward, they had a rather large revenue pickup because it was assumed that these gifts would continue but they would be taxed. Surely, there is going to be a change in behavior. And if Mr. Lindsay's calculations are right, they will not be taxed and there will not be revenue from them in that static model. Wouldn't you just have to assume that?

Mr. **Zonana**. I would presume that, Senator. I think the particular item of tax preference we are dealing with, and that is the contribution of appreciated property to charity, is a very difficult issue. If we were living in a perfect world, we would say that we would have a very broad based income tax and we would have very few deductions, if any, and a very wide definition of gross income, and we would move on from there.

Over the years, we have found it convenient and necessary to provide certain subsidies to meet certain social objections, and education has been one of those and charities has been one of those.

I think in this particular case on a theoretical basis for taxpayers who have very large income, outside income, who are also getting the benefit of a huge deduction by making a contribution and escaping tax on the appreciation, one could argue that as a policy matter looking simply as to whether these people should be bearing their fair share of the burden they ought to be paying tax on that.

On the other hand—and it would be perfectly appropriate to reach an assessment that our support of certain charitable institutions is very important, our budget support has gone down on the actual funding side, and that this is one way of preserving a certain advantage to those institutions. The price we are willing to pay for it is that perhaps a few taxpayers will escape paying some taxes. That is a price we should be prepared to pay. That is a policy call, a judgment call, we ought to make on that basis.

Senator MOYNIHAN. Thank you very much, sir.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bentsen.

Senator BENTSEN. Mr. Hamm, is this bill simplification?

Mr. HAMM. No.

Senator BENTSEN. Well, I have been hanging in there trying to understand all you fellows have said. [Laughter.]

And I sure don't believe it is simplification.

Mr. HAMM. I might say, Senator, that simplification is of prime concern for the bulk of taxpayers. But the minimum tax is really structured toward a few higher income taxpayers who probably should not be the prime forces of tax simplification.

Senator BENTSEN. A little more sophisticated who has an accountant. I understand that. And those accountants get more expensive all the time.

Mr. HAMM. Reasonable. [Laughter.]

Senator BENTSEN. In the eye of the beholder.

Mr. ZONANA. As long as they are not on the accural method.

Senator BENTSEN. Mr. Schapiro, when you say you just don't leave any wriggle room for the fellow that is making an income, I agree with that. That you tighten it up so much I think you get the fellow that also can have an absolute net loss and, in effect, that is an inequity.

Now, Mr. Abbin, you were commenting about this alternative minimum; if we get it too high, it penalizes high-growth, high-investment companies.

I must say I share that. I look at the problem of venture capital in this country and how much we want it, I think, to help start new enterprises, to try to start new types of businesses. And we have got a trade deficit, the biggest in our history. It really gives me a great deal of concern as one who has been a proponent and a sponsor and a principal sponsor of a tough alternative minimum tax bill.

But I would like to have you elaborate, if you will, as to what you think would happen insofar as entrepreneurial starts.

Mr. ABBIN. Well, I think it has a twofold aspect. One, I think it would dampen to some extent the capability of smaller, whether they are merging, startup or just slightly on their way companies, effectively to compete with bigger, more entrenched companies who could form the same operation as a division and have the umbrella of their other operations to offset the deductions and credits whereas that would not be comparable in the startup companies simply because the way the structure of the AMT is with the high rate and the broad based preferences and noncreditability of the R&D credit. It just is noncompetitive.

You have the problem, firstly, of just the venture capital base and competition between small and large. But whatever benefits there are from emerging companies that get the R&D credit based on their acceleration of activities that qualify are taken away by the AMT to a great extent because almost always startup companies, at their inception for a period of time, would be happy to break even.

And, therefore, if you take away a credit, they will still pay tax even though economically they haven't advanced that much, and at a very high rate. And these credits will dangle and linger, and so you have two aspects: The competitive aspects between small, merging and larger; and, second, there comes a point in time when the towel is tossed in and there is too much of an enticement by the larger to join them simply to overcome that competitive disadvantage.

So I see two facets the problem of the small, emerging high technology when you have the type of AMT that 3838 proposes.

Senator **Bentsen**. Well, with the small percentage of them that actually succeed, you have got that kind of deterrent already. And then if you say that they cannot pass through in a limited partnership the losses, you obviously have added a very substantial further deterrent to people.

Mr. **Abbin**. Senator, that is a third element that I did not address. That was the individual investor to venture capital. That is a third element of decision that you have to make on the Senate Finance Committee, and that is how much do you want to encourage this type of thing from the individual investment sector because certainly it is so penalized, if you will, in the AMT.

Senator **Bentsen**. Let me just—my time is running out. I see the Japanese are trying to find ways to emulate us on that for venture capital and now, in effect, we are trying to discredit it and slow it down.

I would like to touch on one other. I notice under the alternative minimum that insofar as the intangible drilling cost that they have stated in the House portion of it that you will only allow the charge off up to 65 percent of net income to be used against your deduction.

I had one so-called independent oil man tell me that what he would now do, he would drill up to 65 percent of his net investment income, and then next year he would drill up to 65 percent of what that was, and the next year 65 percent of that remaining cost. In effect, going out of business. And when we have seen the drillings cut back so much in this country and we are going to be coming more dependent on foreign oil, that, seems to me, counterproductive.

Thank you, Mr. Chairman.

The **Chairman**. Let me start with Mr. Abbin, as Mr. Zonana correctly placed the priority.

If we decide as a matter of policy that we want to make sure that all individuals—not corporations for the moment. I will get to that in a minute—all individuals of wealth pay some tax no matter what their preferences or deductions or sources of income, how should we write that tax?

Mr. **Abbin**. I am not sure I am bright enough to figure that one out.

The **Chairman**. I think Mr. Schapiro has a way of doing it. I am curious if you have an alternative way of doing it, if we start with that presumption.

Mr. **Abbin**. If we are having alternative other than a schedular tax. I am not sure there is.

The CHAIRMAN. I don't care if you call it a schedular class or not. What we want to avoid are the stories in the paper that says 299 or 450 with over $200,000 income paid no tax.

Mr. ABBIN. Would that suppose that you do not delve into whether that happened because of foreign tax credits?

The CHAIRMAN. Correct.

Mr. ABBIN. Or whether it happened for true economic investment, et cetera?

The CHAIRMAN. That is correct.

Mr. ABBIN. On that basis, you might have to move away from an income tax system to accomplish that.

The CHAIRMAN. Well, what suggestion are you making then?

Mr. ABBIN. I am not making a suggestion. I am just bringing up the possibility of certain other approaches of taxation, be they national sales tax, consumption tax, value-added tax, BTT. Many of these can get at what is done with disposal assets. I don't endorse them, but I am suggesting——

The CHAIRMAN. On that basis, I doubt there is a person in this country that doesn't pay some tax. Probably all those people that are avoiding tax may hire one secretary upon whom they pay Social Security tax. So to that extent they are paying some tax.

At the coffee shack or lumber company, they don't count that as a tax. That is an insurance payment. And the value-added tax would not be counted as a tax in their mind.

And I am trying to figure out a way so that the public thinks that the code is fair, and they do not think it is fair if you can avoid paying income tax.

Mr. ABBIN. Well, you can scale back, if you will, the use of preferences and have a very broad list of preferences. I suppose we go back to a proposal that has been hanging around for a couple of years that one of your members cosponsored, the Chafee-Stark or Stark-Chafee. It perhaps will get at that so that no matter what one does under the basic income tax. As you move away and look at some alternatives, that would say that whether it is an abusive tax shelter, a tax shelter, a basic investment or anything else, even a tax-preferred capital gain, only a certain percentage of that can be recognized.

Presumably, if you make that broad enough, you might be able then to catch every fish in the net.

The CHAIRMAN. Well, the reason I ask is you have been rather critical of the House's approach. And we are not necessarily wedded to the House's approach. But if we are trying to find some approach that will catch all of the fish, we need some help from you. Or else if you won't help us, then don't criticize us when we come up with something.

Mr. ZONANA. Senator?

The CHAIRMAN. Mr. Zonana.

Mr. ZONANA. It seems to me that there are two or three approaches that respond to widening that net and catching all the fish.

One possibility would be to follow something like Bradley-Gephardt, and that is a very broad based income tax; all the items are included, very few deductions, lower rates; everybody goes home. That is the end of the story.

With all due respect, Senator Bradley, I don't think that is politically practical at this particular point. And I am not a politician.

Senator **Bradley**. That is right. [Laughter.]

Mr. **Zonana**. The other approach would be something along the Moynihan bill, which is another possibility.

And then a third possibility is to take H.R. 3838 and make sure that at least the majority of the provisions that are now in the alternative minimum tax stay on. But if you eliminate the one that deals with the excess passive activity loss, it seems to me you are still going to wind up with a number of taxpayers not paying any taxes. And despite the fact that we have all of those fact and circumstances issues, which will be a problem—and I recognize that—that may be the only way to approach it.

The **Chairman**. Mr. Hamm.

Mr. **Hamm**. I think you take the House bill, and you take out the excess loss provision, and you think about other economic income concepts that may not be in that bill, and you go with an alternative minimum tax.

You also respond to the criticism that these companies aren't paying tax by making sure that the public understands that many of them are paying foreign taxes, and that it isn't that no taxes at all are being paid.

The **Chairman**. You don't need to answer, Mr. Schapiro, because you have given an answer, and I think it is a valid answer, and you understand the policy alternative.

Mr. **Schapiro**. There just isn't any other way. I don't believe you will find one. And I think if you try to do it, I, as a tax lawyer, will beat you at it. There is no other way than picking out what you are going to tax.

The **Chairman**. Well, I will bet you this committee could draw one that you could not get around.

Mr. **Schapiro**. Not if you are going to allow me any deduction that I can voluntarily take. You just can't do it.

The **Chairman**. You miss my premise. I bet I could draw one that you could not get around with deductions if we limited the deductions you could take or the percentage of them that you could take.

Mr. **Schapiro**. But then you have got to take business income. I think that as long as you are going to permit people to combine activities and not pick out earned income and investment income, you will never succeed in taxing everybody because you are going to be allowing people to spend their money doing other things which they can deduct.

The **Chairman**. Senator Danforth.

Senator **Danforth**. I have no further questions, Mr. Chairman. It is especially good to see John Hamm back. He led me through the tax laws for, what, 3 years.

The **Chairman**. Are you responsible for his theories on taxation? [Laughter.]

Senator **Danforth**. Behind him is Jim Connelly who was his successor.

Senator **Moynihan**. Mr. Chairman, I think it has to be noted that with all the brilliance of this panel they are obviously four very happy people as they contemplate what we are about to do. [Laughter.]

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you.

I guess one of the questions that I get perplexed about in figuring out how to go about structuring any kind of minimum tax in which everybody pays some kind of fair share of the tax burden. I guess, part of the philosophy behind the House bill is that the basic idea should be: any deduction can be defined as a tax preference item, and the way to make sure that people pay their fair share is just to say you can only take 75 percent of that deduction?

What I see over a long period of time—is the ultimate form of tax simplification—First, the rate at which deductible tax preference items may be reduced from 75 percent which is the House rate, to 25 percent, which you might call the ultimate in base broadening and total neutrality, whatever that may be.

One man's neutrality may be another person's call to arms, I suppose. But are my misgivings about that well placed or shouldn't I worry? Is that basically a good road to proceed down?

Mr. Abbin.

Mr. ABBIN. Well, Senator, you commented that you scale back the deductions, et cetera, in the House bill by 25 percent. That isn't quite the way it works.

Senator HEINZ. I understand that, but I was trying to oversimplify the road down which I think the House probably is leading us. I didn't mean to be unfair to the House bill.

Mr. ABBIN. What it does is take a certain stated list of preferences, including certain deductions and also certain imputations, like the value of an incentive stock option and completed contract method of accounting, and so forth, and add them back so you have a mixture of deductions, exclusions and imputation of income.

That becomes very, very complicated in the sense of getting an appropriate valuation of them. But it just taxes them.

Senator HEINZ. And there are certain thresholds, too, in the House bill.

Mr. ABBIN. Yes.

But you scale back. It again gets back to what the Chafee-Stark or Stark-Chafee approach was and that is one way of doing it. And, of course, as we get into both scaled back and/or different rate of benefit, we are approaching the Bradley-Gephardt all over again to some extent.

And it gets down to do you provide enough incentives if you have a different schedular rate, if you will, for deductions and losses than income that earns to provide for those. And that, I think, is both a philosophic and a tax policy decision that we often have different opinions about.

Senator HEINZ. Mr. Zonana, is the House approach going to lead us down to the path that I suggested it could?

Mr. ZONANA. Well, I think the House approach will lead you down the following path: I think having expanded the base against which the alternative minimum tax will be applied, it will catch within its net more taxpayers, capture more economic income and lead to more taxpayers paying what is perceived to be their fair share.

The question that I raise is how complicated has that system gotten to be. It is now a parallel—I perceive it as a parallel tax system which has various pools of income which are measured one against the other.

Senator Bentsen mentioned the intangible cost a few minutes ago, which you look at within a particular pool. You have another pool of income and deductions which is attributable to tax shelters, which is looked at also separately. And then you have got other varieties of pools of income.

I think that is becoming a very complicated system. I am not entirely sure how I would rewrite H.R. 3838. If I had the luxury, I might want to open up the definition of income much more probably and include a number of the deductions in there and just apply a relatively low rate and say that is it.

Mr. HAMM. Senator, let me respond. I share very much your concern about deductions getting scaled back or getting scaled down without regard to what those deductions relate to. Safeway makes a lot of gross receipts, but they may not make a lot of profits. They have got hard expenses like salaries. You want to make sure that we are only scaling back tax preferences rather than real hard expenses, and that is when it becomes a capital tax rather than an income tax.

Senator HEINZ. How do you define the difference between a legitimate deduction and a tax preference?

Mr. HAMM. Of course, that is what we are here to do. It is exactly to set up that list. Accountants have to——

Senator HEINZ. Mr. Chairman, I haven't heard them set that list up yet.

The CHAIRMAN. There would be those who would say that salaries are a preference and you don't deduct them.

Senator HEINZ. Mr. Chairman, I understand that it is in the eye of the beholder. And that is the problem, right?

Mr. HAMM. That is right.

Senator HEINZ. Mr. Schapiro.

Mr. SCHAPIRO. Well, I think that the question you pose is essentially impossible, and for that reason we ought to go about it a different way. And that is not monkey with the deductions, leave our system pretty much as it is in terms of whatever it allows by way of incentives. But go with the problem of trying to correct the perception of people, individuals, not paying taxes. And I think the schedular system in the Moynihan-Chafee bill with whatever rate you want to do does exactly that; is simple; accomplishes all the objectives and leaves the world just to go on with all the good things about our tax system now in and all the advantages that it provides for all the socially desirable kinds of conduct. And it will get everybody to pay some taxes and we will be able to encourage whatever we want in R&D and real estate. And whatever activities we want to encourage, we will encourage them.

But it goes under the heading that we don't say no, no, none of such; we say oh, no, not so much, for any individual.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Thank you very much, Mr. Chairman.

Let me ask you about appreciated property. I guess the theory behind appreciated property is that if I have an asset and I sell the asset and get $100,000 and pay $20,000 in capital gains, then my gift to the institution is $80,000. But if I give the piece of appreciated of property, then the gift is $100,000. Is that basically the benefit to the institution of the appreciated property? That it is greater in amount because you do not have to pay a capital gains tax when you transfer it?

Mr. ABBIN. Essentially, yes.

Senator BRADLEY. Now there is a problem here. In 1983, I think it is, the Internal Revenue Service had a board of appraisers who analyzed a specific number of art gifts and found that 70 percent of the gifts of appreciated property were on an average 300 percent overvalued. So the question is: What do you do about that? Here is someone who is giving a gift that they value as $100,000 when, in fact, it is worth maybe $30,000. They get $100,000 deduction, and the Treasury does not get the tax revenue. You know, that is not the way it is supposed to work, is it? And then if the institution moves to sell the property, they can't get $100,000.

Mr. ABBIN. Well, there have been rules, Senator Bradley, that have been put in so that overvaluation and what is the deduction if the institution that receives property in kind sells it within an established period of time. And that can establish what your charitable contribution is.

What you are getting at, obviously, is a difference between hard-to-value assets, and I suppose the gemstones that went to the Smithsonian is one of the worst examples of that, and listed stock that has an established market and perhaps what you have to do is reflect whether or not the overvaluation penalties and the rules about sale within a certain period of time of receipt, established value, and/or some other mode to take care of the hard to value assets.

But I would suggest at the same time one ought to consider whether in that process of being concerned about these abuses—and some of these obviously were fraudulent transactions with appraisers being bought off, et cetera—none of us would suggest that ought to continue, but at the same time making sure that if you feel comfortable that, shall we say, easy to value, easy to dispose of at that valued price, appreciated assets—stocks, bonds et cetera—ought to be part of the largesse going to institutions like academia or hospitals. You may want separate rules.

Senator BRADLEY. Would the panel be in favor of limiting the gifts of appreciated property to those that have a clear and readily set market value as opposed to those that are extremely esoteric and subject to the kind of abuses that the Internal Revenue Service appraisal panel discovered just last year?

Mr. SCHAPIRO. Senator Bradley, one thing you might do in dealing with this is just sort of adopt a sort of a simple rule. We are trying to get some moneys to charities, and we have a big problem in valuation; let's do a reverse court holding company. If the charity doesn't sell it in 30 days for cash, you get your cost basis deduction. You get whatever you get—whatever the charity gets for sale in cash.

Now that is true we are not going to allow charities to get gifts of Renoirs because they don't want to sell them. But, basically, we have got to compromise something. And if you would like to take care of that problem, which is a very real problem—and the overvaluation penalty doesn't appeal to me at all. It is too hard to administer.

So your rule is you deduct cost unless you make a gift to charity, the charity shows it sold it for cash to an independent third party in 30 days, then you get what that was. And that would take care of that problem, period.

Senator **Bradley**. So you are saying that the charity would get the deduction in excess of cost only if they sold the property within 30 days after receiving it.

Mr. **Schapiro**. For cash to an independent party. Not for notes. For cash.

Senator **Bradley**. For cash.

Mr. **Abbin**. Senator, I would suggest that that approach would take care of a lot of considerations, but what might it do to the collections of Metropolitan Museum of Art and National Gallery, et cetera, of art objects that do stay in their possession for almost forever. I think that perhaps a sale within-30-day rule is much too harsh.

Mr. **Schapiro**. We are talking about a minimum tax. We are talking about a specific problem. You can't solve all the problems in every way, but at least you can deal with the universities that say if you take this away from us we are just going to lose our source of income. OK, that problem you solve with the sale in cash in 30 days.

Maybe people who want to give properties to museums ought to wait until they die and leave it to them. [Laughter.]

Senator **Bradley**. If the university or the institution is in a fundraising drive to raise a hundred million, they have no incentive to say no if someone gives them a gift that is overvalued. Is that not correct?

Mr. **Hamm**. That is correct.

The **Chairman**. Senator Moynihan.

Senator **Moynihan**. Just to note, Mr. Chairman, that in the Deficit Reduction Act of 1984 we substantially tightened up this whole appraisal question, and I think the Treasury is certainly satisfied with it by publicly listed price quotations. There are new things, rules, in place.

If I may say to my friend Bill Bradley: That is a bit of a distraction. There is a market price for most of these things, and where there isn't, there is a lot of can't be. I mean, you know, what is this Monet worth? Well, nobody knows. But on the other hand, it doesn't really matter very much because it isn't on the market, you know. I mean there are just some things there aren't many of, and life will go on with this difficulty. And these are very public things.

Senator Chafee is ill today and is not in his office. He wanted me to say that he wished he were here. He would like to thank you all, especially Mr. Schapiro, whose summation seemed to me masterful. And that is about all I—I think I had better stop right there.

The **Chairman**. I have only one question. It relates to the corporate minimum tax. If we pass 3838 as we received it from the House, will it guarantee that those major American corporations that have been quite profitable and have paid no tax will pay tax?

Mr. Abbin.

Mr. ABBIN. No, because when there is a provision there that if there were 2 out of 3 loss years, and those are tax loss years, you can carry forward your investment tax credits so those companies can be very profitable theoretically and for a period of time not pay tax.

There might be other circumstances, be they foreign tax credits, be they net operating losses, et cetera, that still might preclude some of these so-called big companies that have received notoriety from not paying tax.

I would suggest that most companies who had been on that list for a lot of other reasons and changes in 3838 no longer will make that list if that is a good list to be on.

But I doubt that 3838 will take care of every large company that received bad press on that.

The CHAIRMAN. Do the rest of you agree?

Mr. HAMM. I think eventually you might get to that point. But I think that is his point. The transitioning into the new AMT may result in, next year you may have the same list of nontaxpaying companies.

Mr. ZONANA. I agree with Mr. Abbin.

The CHAIRMAN. Mr. Schapiro?

Mr. SCHAPIRO. I think the problem, Mr. Chairman, is that really we have to identify what are the companies we are after a little more carefully. And I think if we analyzed the cases that we are really out to get, that we would be able to take 3838 and fix it up to do that.

For example, in the foreign tax credit——

The CHAIRMAN. Well, don't answer more than I want.

I don't want anybody to be under the illusions that if we pass 3838 those corporations that pay no tax may, or that no other corporations can escape paying tax. Thirty-eight thirty-eight, to that extent, does not work as a guaranteed corporate minimum tax, does it?

Mr. SCHAPIRO. That's for sure.

The CHAIRMAN. So if we do not fix it up, if the goal is to guarantee a payment of a tax, the House bill fails in that respect.

Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you.

The Ways and Means Committee tax package has a very narrow spread between the alternative minimum tax and the regular tax—25 against 38 percent maximum for individuals, 25 versus 36 for corporations.

What does that imply that the rate for the alternative minimum tax ought to be? I think all of you have said at one time or another it is too high.

Mr. HAMM. That is right.

Senator HEINZ. How do we set it so that it isn't too high?

Mr. ABBIN. Senator, from past experience, the rate for individuals was 40 percent of the basic rate for the last few years, that is, 20-percent compared to 50. If you look at any of the proposals now in the range of 33, 36, 38, you are talking about a 14- or 15-percent rate; coincidentally, the same as Senator Moynihan's rate on a different tax system. And once you get beyond that with the rate at the top being between 33 and 38, I would suggest you find that the

AMT has a life of its own; it is a separate tax system that isn't at all coordinated or correlated with our basic system and causes a great deal of——

Senator HEINZ. I understand that concern. I am just asking how do we set the rate.

Mr. ABBIN. I think it needs to be reduced perhaps 10 percentage points.

Senator HEINZ. Mr. Zonana.

Mr. ZONANA. I think you would have to rely on a lot of estimates as to how many taxpayers will be impacted, the classes of adjusted gross income that will be impacted, how much money will be raised, and things of that nature.

I don't have a fix on that, and I don't know that those numbers have been developed yet.

Senator HEINZ. Under 3838, can wealthy taxpayers still escape paying taxes?

Mr. ZONANA. Don Schapiro assures me that he can devise some strategy.

Senator HEINZ. Yes, I heard him.

Mr. ZONANA. I suppose you could do that. I will consult with Don. Yes, I think you can.

Senator HEINZ. Mr. Hamm.

Mr. HAMM. As far as the rate goes, it is very difficult to say exactly what it should be. I say between 15 and 20 percent would be a reasonable figure given the reduction in the maximum ordinary rate.

Senator HEINZ. Mr. Schapiro, even though you don't like this approach——

Mr. SCHAPIRO. No, I like it fine. You just asked the question. What rate do you put on earned income is the way I would ask it. And the answer I would give is I would really like to work with the revenue estimates as Mr. Zonana said. I think you have to do it with the exemptions and see where it comes out so that it catches the things you are trying to do. And if you work against a model, normally, you can come out with a pretty sensible answer if you put it on a screen.

Senator HEINZ. And what are you trying to optimize? Are you trying to optimize the number of people you catch? The amount of revenue you raise? What are you trying to optimize?

Mr. SCHAPIRO. No; what I am trying to optimize is this: I am leaving revenue considerations aside totally because that certainly is not my bag as a technician. That is rates overall and kinds of taxes.

What I am trying to optimize is the two competing policies of the tax. One, you want a tax system which will encourage certain types of activity—R&D or whatever it may be. Second, you want a tax system which will be perceived as being "fair." And if I thought within that framework is what I would try to do. And under the Moynihan-Chafee bill, I would catch investment income, earned income, see what it amounts to, see what it looks like, and probably what I would do is I would put on the lowest minimum tax rate that would be perceived as being fair against the kind of a grid I had. And then I would have the rest of my tax operate with the normal kinds of deductions and exemptions in order to encourage the economic activity we want. That is the way I would do it.

Senator HEINZ. Let me ask a different question.

I think some of you—at least in summaries of your testimonies that I have received—have said that the alternative minimum tax in 3838 will penalize growth companies. How many of you feel that way? Do you feel that way, Mr. Schapiro?

Mr. SCHAPIRO. I really don't have enough basis to feel that way. Growth companies are penalized today because they don't have income against which they can offset it. So I would just have to pass on the question.

Senator HEINZ. Mr. Hamm.

Mr. HAMM. I think that probably is the case with regard to growth companies that have tax credits built up from past experience that will not be able to utilize them against their alternative minimum tax in the future.

Senator HEINZ. Mr. Zonana.

Mr. ZONANA. I agree with Mr. Hamm.

Mr. ABBIN. Definitely, sir, yes.

Senator HEINZ. Definitely hurt growth companies.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. I would like to come back to the comment that you made, Mr. Zonana, about another way to do a minimum tax, whereby instead of an alternative minimum tax you simply make the deductions deductible against not all of your rates but only some of your rates. For example, if you had a tax system that had rates at 35, 25, and 15 but you made deductions only against a 25-percent rate, wouldn't you, in effect, have a 10-percent minimum tax?

Mr. ZONANA. I believe that you would under that approach, sir.

Senator BRADLEY. And it would not be a separate system.

Mr. ZONANA. No, I don't believe it would be a separate system. The question I would ask is what sort of distortions might it create and behavioral patterns might it suggest in terms of the planning that is involved. I haven't thought that through completely.

Mr. ABBIN. Senator Bradley, I would suggest that in that process you would have more than a 10-percent minimum tax because if all your investment activities provided at 25-percent deduction benefit and income therefrom came in at 35, that in some respects you have a higher rate economically than 35 percent on your net stream of income flow. So it is an automatic part of your tax system. It isn't a minimum. It is part of your effective tax rates under one system.

Senator BRADLEY. But the result would be the same, and that is the value of—instead of sweeping it all into an alternative minimum tax, you would simply limit the amount it could be valued under the present——

Mr. ABBIN. Mechanically, it works that way, but I think in a sense of economic investment it would be perceived far differently than that.

Senator BRADLEY. Well, let me ask you, How much of your judgment is determined from the fact that there would be the effect of a 10-percent minimum tax and how much is determined from the fact that the rates would drop from 50 to 25?

Mr. ABBIN. Obviously, there is a mixture of both in anything we say, I think.

Senator BRADLEY. Yes. I think so—anyone else want to offer an opinion on that? [No response.]

I finally have a question that they don't.

Let me go back to the first question, because I think that is a problem the committee is going to have to grapple with.

The House bill which has been produced has a certain distribution of tax burden. And a part of the House bill is a 25-percent minimum tax with a very broad base. It includes appreciated property, interest, all of these other things.

To the extent that you remove from that base appreciated property, for example, or interest or any of the specific preferences that are used disproportionately by upper income individuals, and to the extent that you cut the tax rate from 25 to 15 percent, in order to maintain the same distributional neutrality you will have to make other moves to offset the cut in tax on upper income individuals. Is that correct?

Mr. ABBIN. Yes. And isn't that essentially what Bradley-Gephardt was all about? So we are just extending the——

Senator BRADLEY. That was the last question. I want to get beyond that.

Mr. ABBIN. No; but I think that this brings that same mode of thing. And, yes, that can accomplish it.

Mr. HAMM. I think as far as taking out from the minimum tax the preferences that high income people use, you are correct. I don't think that is the case with lowering the rate. Lowering the rate will, in effect, knock out other lower income people who are brought into the alternative minimum tax by its higher rate.

Senator BRADLEY. I don't follow that.

Mr. HAMM. Well, if one's ordinary income tax rate is 22 percent, for instance, and you may find yourself in the alternative minimum tax percent of 25 while another individual is in the 36-percent ordinary income tax bracket may not be in the alternative minimum tax. Lowering the rate from 25 to 20 percent may knock out the lower income person; not the higher.

Senator BRADLEY. Mr. Schapiro.

Mr. SCHAPIRO. It is no doubt true that if you cut down the minimum income tax base you are going to get less money from it. And if you get less money from it, you are going to have to get that money some place else. I think that is true—which is really, I think, what you said, isn't it?

Senator BRADLEY. And that it has distributional effects.

Mr. SCHAPIRO. Of course. I mean essentially that has to be the case. That is the revenue impact. That is not really dealing with the philosophy of it. That is just the practice, practicality. Sure.

Senator BRADLEY. Thank you very much.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Mr. Chairman, the following is not a proposal; it is an idea to see if I can understand better the dynamics of how we might deal with the notion of having an adequate and fair minimum tax that gives the kinds of incentives Mr. Schapiro was saying that we want to give for economic activity.

What made me think of this is that we currently limit the amount of investment tax credit that may be taken to 85 percent of the tax liability of the corporate taxpayer. Could we use in some sense the same approach—and here let us talk about individuals—such that we had a minimum tax where the individual could take deductions only up to *x* percent in this analogy, 85 percent, you fill in the number—85 percent of gross income, assuming that gross income is an adequate—is adequately defined.

I realize that we would have to exclude in terms of a corporate approach things like net operating losses and actual cash losses. What would be the effect of that kind of an approach? Would it work? Would it have some side effects? What would those be? Anybody want to take a crack at that?

Mr. SCHAPIRO. Let me try to take a crack at that.

It seems to me that implicit in the question is the assumption of various kinds of deductions. You haven't stated it, but I think it is implicit. But let me start out with a grocery store.

Senator HEINZ. Well, let us try and focus on individuals.

Mr. SCHAPIRO. Fine.

Senator HEINZ. On the business side, obviously, you are talking about legitimate deductions. Safeway, and 98 percent of their gross income goes to——

Mr. SCHAPIRO. I am an individual. I am practicing law and the same problem arises. What do we do with my deductions for my rent and secretary? That has to be fully deductible in any income tax system.

Now as I go down the line of deductions, what about deductions for bar association dues; what about deductions for travel; what about deductions for depreciation?

Senator HEINZ. Some of us aren't lawyers, you know, and the more you tax something, the less you get of it. And if there is anything we could do about the number of lawyers through the Tax Code, we would be tempted, I think, in trying to.

Mr. SCHAPIRO. I could work the same questions for accountants, for advertising.

Senator HEINZ. You are on a roll. [Laughter.]

Mr. SCHAPIRO. The point I am making, sir, is that the assumption that there are deductions of different classes is implicit, I think. So the first thing you would have to do is you would have to define business deductions of a kind.

Senator HEINZ. Yes.

Mr. SCHAPIRO. Fine. Now you are going down to sort of discretionary deductions, itemized deductions, and you are beginning to talk about deductions either from other classes of income or other kinds of activities and so forth, and the problems of defining that kind of a distinction in deductions would be Herculean in terms of its applications.

And while I think you could say in the case of itemized deductions you can only take so much of your charitable contributions, or, indeed, as it was suggested in the New York Times, so much of your State——

Senator HEINZ. The approach I am suggesting is different than that. The approach I am suggesting—and let's simplify it and say we are talking about individuals with incomes of more than

$200,000, and people below that, we will figure out some other system; maybe none at all.

But Senator Packwood mentioned those people, and those are the ones that get the stories. And we say to them, look, you can take all the deductions you want except for one thing. There is a limitation of 85 percent of your gross income. It is like the old charitable deduction limitation. There is only so much that you can take in aggregate. And if you want to give away more to charity than 85 percent of your gross income, fine, go right ahead, but you are not going to get a deduction on that portion of it but more than 85 percent of gross income.

That is different than saying we are putting a 15-percent tax on certain tax preferences, which is more or less the approach that the House is akin to.

Mr. **Schapiro**. You are suggesting it has to be nonbusiness deductions only. We will only give you a certain percentage of your nonbusiness deductions.

Senator **Heinz**. Yes. Let us assume that we can agree on a reasonable list of tax preferences.

Mr. **Schapiro**. If you can do that, you can solve the problem relatively easily. And then you have got to deal with the question of combining businesses. Someone is in business A and business B and business A has income and business B has losses. What do you do in that case? They are both businesses.

Senator **Heinz**. That leads me to my last question. That leads me to kind of another probably—certainly on my part not very well thought out idea, but since none of us seem to have better alternatives, let me float one on you.

One of you has proposed the—what do you call it—schedular tax. And I don't pretend to understand it. I just skimmed through it a few minutes ago. But suppose you did something like this: You said, all right, anybody who has got gross income of more than $200,000 is going to be on one of two tax systems—the current tax system, whatever it turns out to be, or idea *x*, which in this case, happens to be the schedular income tax. And you pay whichever is greater.

Mr. **Schapiro**. That is exactly what the schedular tax system does precisely.

Senator **Heinz**. But we only apply it to those people who have a gross income of more than *x*.

Mr. **Schapiro**. That is what it does now. What it does it has an exemption amount or a deduction amount. Sure. That is absolutely right.

Senator **Heinz**. Let me ask your colleagues there what about that approach. What are the flaws in that kind of an approach? Mr. Hamm?

Mr. **Hamm**. The problem that we discussed earlier was that some of that may well be hard deductions. Some of those may be investment expenses that are not preference oriented. It is not accelerated depreciation. It is straight-line depreciation.

Senator **Heinz**. So there is an unjustified taxation of economic income under that approach?

Mr. HAMM. Literally a tax on capital as opposed to a tax on income—I mean you have no economic income; you have expenses, hard expenses, equal to your income and yet you are getting taxed.

Senator HEINZ. All right.

Mr. SCHAPIRO. I would say exactly the same thing it has done for capital losses, which I have said before. If I in my hated legal profession earn $100,000 and have $100,000 capital loss, I have no real income and yet I have tax. And it is done today. There is nothing in nature which says you can't do that.

Senator HEINZ. Mr. Zonana, Mr. Abbin, do you have anything to add to the discussion?

Mr. ZONANA. My preference, Senator Heinz, remains with respect—is the alternative minimum tax as we now have it with an expansion of the items and probably a rate somewhere between 15 and 20 percent. In other words, following the approach of H.R. 3838 because I think it does get to the broader definition of income that I think we should be looking for, economic income.

Senator HEINZ. Mr. Abbin.

Mr. ABBIN. Senator Heinz, my concern with the schedular approach simply is that those—and perhaps $200,000 and above is a very significant earning level. There aren't many people in this country who do so. But a number of people in that category are not capital wealthy. They are salary income very well off.

For them to do any type of investment to generate capital, you put them at a disadvantage compared to the super wealthy who don't have the same problem. And I think you are getting into a middle, upper class consciousness that gives me some pause. That it works well at a certain level, but when you get to a certain ultimate level of wealth, they can disdain and thumb their noses, and it still will not harm them. And I think the schedular approach certainly has that inherent in it.

Senator HEINZ. Mr. Chairman, I just want to say that I commend you on this hearing. It is certainly one of the more interesting as well as one of the more frustrating hearings that I have participated in. It is not frustrating because the witnesses are inarticulate or unknowledgeable or unintelligent. To the contrary. They are exceptional witnesses.

But I think what we have learned is that doing this right—and it is something that I think we are all almost committed to doing in one way or another, some shape or form, and it is enormously complex and difficult. And what we want is fairness, but we don't want to pay too much of a price whether it is capital formation or economic growth. We don't want to be unfair, but also don't want taxpayers to be perceived as cheating the system.

I think you have made us all more aware of the issues and problems, and we want to thank you for letting us do all the tough decisionmaking. [Laughter.]

We were hoping for a little more help, but the buck stops here.

The CHAIRMAN. Actually, I think they have been quite helpful because there are two problems of fairness. One, we want the public to perceive the code as fair and everybody to pay some taxes. What you are saying from a very practical standpoint as you fill out tax forms you can achieve that all right, and what you may do is cause unfairness to other taxpayers who are going to pay taxes when they have no income. And how do we balance those two concepts of fairness.

Very, very helpful.

Gentlemen, thank you very much. We are adjourned until tomorrow.

[Whereupon, at 12:03 p.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

AGA
American Gas
Association

INGAA

JOINT STATEMENT OF
THE AMERICAN GAS ASSOCIATION
AND THE
INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA
BEFORE THE
SENATE FINANCE COMMITTEE
ON THE ALTERNATIVE MINIMUM TAX
PROVISIONS OF H.R. 3838
THE TAX REFORM ACT OF 1985
FEBRUARY 3, 1986

INTRODUCTION

The American Gas Association (A.G.A.) is a national trade association composed of nearly 300 natural gas distribution and transmission companies. Together, these companies serve over 160 million U.S. consumers in all 50 states. A.G.A. member companies account for approximately 85% of the natural gas utility sales in our nation each year. The Interstate Natural Gas Association of America (INGAA) is a national trade association comprising member companies which account for over 90% of all natural gas sold in interstate commerce and subject to the jurisdiction of the Federal Energy Regulatory Commission as mandated by provisions of the Natural Gas Act (NGA; 15 U.S.C. 717 et seq.) and the Natural Gas Policy Act (NGPA; 15 U.S.C. 3301 et seq.).

A.G.A. and INGAA are pleased to offer our comments on the operation of the alternative minimum tax (AMT) contained in H.R. 3838, particularly with respect to its effect on general business credits and intangible drilling costs. The natural gas industry does not oppose the concept of an AMT that merely affects the timing of a corporation's tax payments.

We support the provision of the AMT that allows a credit against future regular tax, and we strongly recommend that this provision be a part of the Senate tax reform legislation.

However, we believe that the AMT of H.R. 3838 may cause general business credits to expire unused in the case of taxpayers who are in a credit carryover position. To prevent this phenomenon, we recommend that the general business credit should be allowed to offset up to 75% of the AMT. As an alternative, the AMT should be modified to ensure that general business credits do not expire unused where the credits could have been used to offset regular tax liability in the absence of an AMT.

Also, we believe that the rate of this AMT is too high relative to the regular tax rate proposed by H.R. 3838. This narrow difference in rates would sweep many taxpayers who already pay a substantial amount of federal tax into the net of the AMT. To avoid this result, we recommend that the AMT rate not exceed 50% of the regular tax rate.

With respect to the characterization of intangible drilling costs as a preference item, we believe that H.R. 3838 should be clarified. Because IDC and income from production of a well may not occur in the same year, the amortization offset should be utilized against all excess IDC incurred by a taxpayer, not just the IDC that is incurred in the taxable year.

THE INTERACTION OF THE PROPOSED CORPORATE ALTERNATIVE MINIMUM TAX WITH GENERAL BUSINESS CREDIT CARRYOVERS

The AMT proposed by H.R. 3838 is not intended to impose an additional tax burden on the corporate taxpayer. Rather, the provision is intended to require corporations with economic profits to pay a minimum amount of tax, even though certain preference items would have reduced tax payments below this minimum level. The fact that the AMT was intended merely as a tax payment acceleration mechanism is confirmed by the presence in H.R. 3838 of new I.R.C. Section 53, which provides for a future credit against the regular tax for any AMT paid.

The AMT proposed for corporations by H.R. 3838 generally cannot be reduced by general business credits. Many taxpayers that have recently experienced tax losses or depressed taxable income have carryovers of general business tax credits. These carryovers typically must be used within a fifteen year period. The carryovers expire if not used during this period.

The general business credits of taxpayers in a credit carryover position at the date of enactment of the AMT may ultimately expire unused solely because of the AMT. Under current law, the amount of general business credits that can be used in a taxable year is limited to 85% of regular tax. H.R. 3838 would amend this tax provision so that the offset of regular tax would be limited to the lesser of: (1) the credit available; (2) 75% of regular tax; or (3) the excess of regular tax over the AMT. A.G.A. and INGAA have no objection to the first two limitations and believe that they represent reasonable tax policy. The third limitation, however, inappropriately may result in the loss of general business credits for those taxpayers who, at the date of enactment, are in a credit carryover position.

Ignoring the effect of the AMT under H.R. 3838, a taxpayer could offset up to 75% of regular tax with available general business credits. Application of the AMT, however, lowers this utilization percentage to 30.56% for a taxpayer with no AMT preference items or adjustments (see Exhibit 1). If the taxpayer has AMT preferences or adjustments, the effective credit utilization percentage is further reduced due to the fact that the 25% AMT rate is so high in relation to the 36% regular tax rate. These low utilization rates may cause credits to expire (i.e., credits that otherwise would remain available absent the AMT) for many taxpayers who, although paying substantial amounts of tax, are unintended victims of the AMT.

Since the AMT was not meant to impose an additional permanent tax burden, we do not believe that it should operate in any manner that causes general business credits to expire unused. Ideally, we believe that the general business credit should be allowed to offset up to 75% of the AMT. In the alternative, if the revenue loss from allowing these credits to offset the AMT is too great, we propose that the general business credit allowable in computing the regular tax liability in any year be limited only by the lesser of the credit available or 75% of the regular tax. Of course, this proposed credit limitation would, in many cases, cause AMT to be payable. However, the AMT credit would be subject to the indefinite carryover rules. See Exhibit 2 for an illustration of this proposal. We believe that this modification to the AMT provisions of H.R. 3838 is consistent with Congressional intent and is equitable to the taxpayer and the public interest in raising revenue.

PROPOSED RATE OF THE ALTERNATIVE MINIMUM TAX

We believe that the 25% AMT rate is too high relative to the proposed regular corporate tax rate of 36% and may cause the AMT to become widely applicable to taxpayers who already pay a substantial amount of federal income tax. This is inconsistent with the AMT's purpose of ensuring that profitable companies with significant tax preferences do not defer tax liability entirely. A lower AMT rate could still accomplish this purpose but would prevent application of the AMT to corporate taxpayers who lie outside the intended purpose of the provision. We recommend that the AMT rate not exceed 50% of the regular tax rate.

DEPRECIATION SYSTEMS USED TO CALCULATE THE AMT PREFERENCE

The industry believes that the method of calculating depreciation as a tax preference item under H.R. 3838 would place an unwarranted and unnecessary burden on business taxpayers by requiring them to maintain another set of depreciation records. We recommend that, when calculating a depreciation preference for AMT purposes, the excess over straight line should be calculated using only depreciation records otherwise normally kept by the taxpayer. For example, the AMT could determine excess depreciation by comparing pre-1981 methods, ACRS, and the method finally adopted in a tax reform package to straight line depreciation attributable to the same lives allowed under those methods. This would eliminate the need to begin keeping another set of depreciation records that compares the method of a tax reform package to the class lives contained in the Asset Depreciation Range system.

INTANGIBLE DRILLING COSTS AS A TAX PREFERENCE

H.R. 3838 would treat excess intangible drilling costs (IDC) as a tax preference item to corporations in the same manner that Section 57(a)(11) of the Code currently applies to individuals. Thus, the amount by which excess IDCs from all properties exceed 65% of the net income generated by all of the properties would be subject to the AMT. For these purposes, "excess IDC" is defined as the difference between the amount expensed (pursuant to Section 263) and that which would have been allowed had the costs been capitalized and amortized over

10 years. However, no final regulations have been issued under the existing section and temporary regulation Sec. 7.57(d)-1 may, by inference, preclude the amortization of IDC incurred before the well is placed in service. This would create a result that was never intended by Congress: the sum of IDCs incurred on a well-by-well basis would be treated as a preference item to be offset by 10% of only those IDCs incurred in the year production started. Therefore we believe that any proposal should make it clear that the ten-year amortization offset should be utilized against all excess IDC incurred by a taxpayer with respect to each and all wells since there will be little, if any, IDC after production has started.

CONCLUSION

The purpose of an AMT is to accelerate tax payments by ensuring that profitable enterprises pay some amount of tax during years when they have substantial tax preferences. We do not object to this purpose, provided that a credit for the AMT against regular tax liability in a subsequent year preserves the nature of the AMT as a mechanism for affecting only the timing of a corporation's tax payments. Because the mechanics of the AMT in H.R. 3838 would, in some cases, produce inequitable results, we believe that the Senate tax reform bill should make certain corrections to the AMT. As noted above, these corrections include a provision that prevents the expiration of credit carryovers, lowering the AMT rate relative to the regular tax rate, and making sure that IDCs are characterized as a preference item in such a way as to avoid producing an inequitable result.

Exhibit 1

Interaction of Alternative Minimum Tax (AMT) and General Business Credit Under H.R. 3838

	198X
Regular Tax	
Taxable Income	$5,000,000
Regular Tax @ 36%	$1,800,000
General Business Credit Offset: (Section 38(c)(1) as Amended by H.R. 3838) Lesser of:	550,000*
(1) Credit Available (1,000,000 avail. in 198X; expires in 198X if not used)	
(2) 75% of Regular Tax	
(3) Excess of Regular Tax Over Alternative Minimum Tax	
Net Regular Tax Liability	$1,250,000
Alternative Minimum Tax	
Taxable Income	$5,000,000
Preferences: None	0
AMT Taxable Income	$5,000,000
AMT @ 25%	$1,250,000
Less: Regular Tax Liability	1,250,000
Tax Increase Due to AMT	0
Total of Regular Tax and AMT	$1,250,000

Notes:

- Solely because of the AMT, only $550,000 of the general business credit can be used in 198X. The remaining $450,000 expires unused.

- Without the AMT, the entire $1,000,000 general business credit could have been used.

- The effective percentage of credit utilization to regular tax is ($550,000/$1,800,000) or 30.56%. This effective percentage is significantly below the statutory rate of 75% because of the AMT.

*This number represents the excess of the regular tax over the AMT ($1,800,000 - $1,250,000 = $550,000).

Exhibit 2

Interaction of Alternative Minimum Tax (AMT) and General Business Credit Under Proposed Method

	198X
Regular Tax	
Taxable Income	$5,000,000
Regular Tax @ 36%	$1,800,000
General Business Credit Offset: Lesser of:	1,000,000
(1) Credit Available (1,000,000 avail. in 198X; expires in 198X if not used)	
(2) 75% of Regular Tax	
Net Regular Tax Liability	$ 800,000
Alternative Minimum Tax	
Taxable Income	$5,000,000
Preferences: None	0
AMT Taxable Income	$5,000,000
AMT @ 25%	1,250,000
Less: Regular Tax Liability	$ 800,000
Tax Increase Due to AMT	$ 450,000
Total of Regular Tax and AMT	$1,250,000

Notes:

- Unlike Exhibit 1, no general business credits expire.
- The $450,000 of AMT can be credited against future regular tax liability, subject to the statutory limitations in H.R. 3838.
- The total tax payable in 198X is $1,250,000, which is the same as Exhibit 1.

Statement of

The Associated General Contractors of America

Presented to the

Committee on Finance

United States Senate

February ~~17~~ 3, 1986

On the Topic of

Comprehensive Tax Reform

AGC is:

- More than 30,000 firms including 8,400 of America's leading general contracting firms responsible for the employment of 3,5000,000-plus employees;

AGC members complete:

- More than 80% of America's contract construction of commercial buildings, highways, industrial and municipal-utility facilities;
- Approximately 50% of the contract construction by American firms in more than 100 countries abroad.

The Associated General Contractors of America (AGC) represents more than 32,000 firms, including 8,400 of America's leading general contracting companies. These member firms perform more than 80 percent of America's contract construction of commercial buildings, highways, industrial and municipal-utility facilities. We appreciate the opportunity to submit a statement on the topic of comprehensive tax reform.

AGC's statement will concentrate primarily on the tax reform provisions which will affect the use of the completed contract method of accounting in the construction industry. Without reservation, and uniformly throughout the industry, we oppose those provisions.

We will also discuss the industry's concerns regarding other provisions of proposed comprehensive tax reform. AGC has taken great care to analyze the impact of these other proposed changes on both our industry and the U.S. economy as a whole. We have concluded that the proposed changes would adversely impact the construction industry and capital formation, and therefore we oppose the comprehensive tax reform legislation passed by the House of Representatives, H.R. 3838.

The relationship between a sound and healthy construction industry and a sound and healthy economy demands a thorough analysis. Consider these facts:

- The $348 billion construction industry is the largest goods-producing industry in the country. Whether measuring employment, the value of goods produced (shipments for manufacturing or construction put in place), or what the industry contributes to the gross national product, construction comes out ahead of autos, steel, or any other manufacturing industry.

- The construction industry employed 4.3 million workers in 1984 and the number of workers on industry payrolls has continued to grow, reaching 4.8 million by December of 1985. In 1984 construction employers provided 4.6 percent of the jobs in the U.S. economy. Another 4.5 percent can be attributed to supplier industry jobs, with an additional 7.8 percent induced in other sectors by the ripple effect of construction activity.

- Construction is an unusually productive industry; because dollars invested in construction are spent on wages, supplies, and materials used in construction. Additional economic growth is created by each $1 spent on construction.

- Although estimates of the economic growth created vary according to the method used to construct the multiplier, each

$1 invested in construction adds $2.23 worth of economic transactions to the economy, incorporating payments to suppliers and their payments to other industries, and so on. An estimate of federal construction spending concluded that each $1 invested in the nation's infrastructure added $2.35 to the economy. Over time, each $1 may be responsible for adding as much as $2.80 to the nation's economic potential.

- Over 61 percent of the inputs to the construction process are purchases from other industries while another 30 percent is labor services. Construction, while constituting 8.5 percent of the gross national product on its own, also supports many supplier industries. As much as 14 percent of the gross national product may depend directly or indirectly on construction.

It is a certainty that changes that adversely impact the construction industry will surge throughout the entire economy.

A significant adverse impact on individual construction firms will result from provisions which will severely limit the use of the completed contract method of accounting in the construction industry.

The Completed Contract Method of Accounting

Background

At the outset, we must emphasize that the construction industry is not the source of any problems with the completed contract method of accounting. It was used by and widely accepted for the unique nature of the construction industry as the appropriate financial accounting method even before the enactment of the income tax.

We must be equally emphatic that elimination of the completed contract method of accounting for the construction industry will quickly bankrupt thousands of construction firms and will also have a devastating impact on competition in our industry.

The completed contract method of accounting is a method of reporting income (gain or loss) for tax purposes from long-term contracts. It was first included in Treasury Department regulations in 1918 as the appropriate accounting method for construction contractors following the enactment of the modern business income tax in 1916.

The completed contract method requires a contractor to wait until a contract is finally completed and accepted before reporting a gain or loss from the contract for income tax purposes. The method is the most accurate method for determining gain or loss on construction contracts. The method meets the requirements of the "all events test" for determining income due to the inherent risks and the unique nature of the construction industry. The all events test requires that a taxpayer perform all responsibilities necessary to earn income or realize a loss before it can be declared a gain or loss. The completed contract method mirrors this requirement by recognizing the fact that until a project is completed and accepted by the owner the contractor has no certain claim to either a gain or loss from the contract.

From 1918 to 1976 the completed contract method was limited to construction, building and installation contracts. These are the traditional types of contracts found in the construction industry where the taxpayer builds a single project. They include all forms of contracts for the construction of industrial, highway, and single structures and the various subcontracts required in the construction of the projects.

During the 1960's a variety of other types of contracts attempted to qualify for the completed contract method by judicial interpretation under one of the three traditional categories of long-term contracts. Following this litigation the Treasury Department fully revised the regulations concerning the eligibility and use of the completed contract method of accounting in 1976. A new category of long-term manufacturing contracts was added to the eligibility list for completed contract reporting. As a result of the 1976 regulations, groups now using the completed contract method include construction, shipbuilding, aerospace, weapons manufacturers, heavy equipment manufacturers and a variety of other manufacturers.

The completed contract method has been the appropriate method of reporting income from construction contracts for the last 69 years because of the unique nature and inherent risks of the construction industry. These risks and the unique nature of construction do not permit a contractor to realize any gain or loss from his performance of a contract until it is completed. Only after a contractor performs all his contractual responsibilities can he determine a gain or loss.

The unique nature of construction and the inherent risks of construction are as great and significant today as they were 69 years ago. These factors unique to construction include:

- differing sites for each project with varying soil conditions

- varying and unpredictable climate and weather conditions

- firm prices for the duration of a contract which require the contractor to bind himself to a price before actual costs are known

- owner retention policies under which owners typically retain a percentage of the contract cost from progress payments until all work is complete and accepted

- changes, modifications or claims during the course of the contract which require the contractor to spend large sums in advance of this contractual right to fully collect contract revenues from the owner

- intense competition within the industry, resulting in exceedingly small profit margins, both in relation to total receipts and in comparison with other industries. One study by a nationally-known consulting firm calculated the net operating margin for 62 general, heavy, industrial, and process plant construction firms at 1.6 percent (most recent fiscal year).

These risks are not found in other industry users of the method. These variables necessitate that profit on a construction contract be reported only after contract completion and acceptance, when gain or loss is known and certain.

Virtually all construction contracts have retainage provisions where the owner retains part of his payments until contract completion. In some instances the retainage arises through a contractual provision for progress billing, in others there is a specific retainage of a percentage of the portion of the contract price. Retainage in most cases is equal to or exceeds the total profit from the contract.

Retainages are also often used for corrections or defects after project completion. In all cases, retainage is not released to the contractor until after project completion. Consequently, the profit element of a construction contract is not received until retainage is released.

Recent Regulatory and Legislative History

The completed contract method of accounting as currently used is the result of a five-year dialogue between the industry and the Treasury, commencing with proposed regulations in 1971. After two revisions, final regulations were published by the IRS in 1976 providing specific administrative rules for taxpayers electing the method.

Under the regulations, all direct material and labor costs are allocated to the long-term contract and therefore are not expensed immediately, but only deducted at contract completion. In addition, 28 categories of indirect costs were specified. Under current regulations for long-term contracts 15 of these cost categories are allocated to the specific contract and deducted at contract completion.

Thirteen cost factors were thought to be appropriate current business operations expenses which should correctly be deducted in the year in which they are incurred rather than allocated to a contract. These costs, known as period expenses, include items such as general and administrative expenses, marketing, selling and bidding expenses, and interest. For example, janitorial expenses at a home office are not a cost which can be logically allocated to a specific contract in any administrable manner since it is a necessary cost for all of the business operations of the contractor.

The 1976 rules are still used by virtually all construction contractors and were approved legislatively in the Tax Equity and Fiscal responsibility Act of 1982 (TEFRA). The 1976 rules reflected the 58 years of experience accumulated by the IRS in administering completed contract reporting by the construction industry and are regarded as fair by the industry for reporting income. They are based on traditional accounting principles and reflect basic tax policies of the Code.

As a result of the 1976 regulations, certain long-term manufacturing contracts could elect to use the accounting method for the first time. Prior to 1976 only taxpayers performing construction, building and installation contracts could use the completed contract method for income tax purposes. After several years the Treasury Department identified a variety of abuses of the method as it was being applied in the manufacturing industries.

For example, certain contract completion dates were being extended by contract duties which were merely incidental responsibilities. Contracts were being extended past their natural completion dates by increases in the number of units to be delivered under the original contract, such as adding-on to the number of planes or missiles being built. Abuses of this sort simply cannot occur in the construction industry, but did appear in some manufacturing industries.

The Treasury also asserted that the cost allocation rules (used to measure gain or loss) did not match items of income and expense accurately. This assertion was made primarily because of exceptional duration manufacturing contracts of 10-20 years which are not found in the construction industry.

As a result of some of these problems, in 1982 the Treasury Department proposed replacing the completed contract method of accounting with a new method of accounting known as the progress payments method. The Treasury also proposed an alternative option of changing the cost allocation rules, contract completion rules, and rules for severing and aggregating contracts. The Treasury dropped its progress payment method of accounting proposal during the legislative hearings preceding the enactment of TEFRA after the construction industry identified numerous flaws in the proposal.

Congress then dismissed many of the theoretical positions in the Treasury's alternative recommendations as being inconsequential as they would apply to the construction industry and directed that none of the new cost allocation rules in TEFRA for extended-period long-term contracts be applied to construction contracts lasting less than 36 months or to any construction contractor with less than $25 million in annual gross receipts.

Congressional action in 1982 was a direct result of the recognition that fundamental differences exist between the diverse industries now being allowed to use the completed contract method. Congress chose to require these revised cost accounting rules for extended period long-term contracts be applied to all manufacturing contracts lasting longer than 24 months, regardless of the manufacturer's size. The other aspects of the TEFRA completed contract provisions (new contract completion, severing and aggregating rules) did not apply to construction, as the industry pointed out, and no specific exceptions were necessary.

The Administration's recognition of the importance of the traditional use of the completed contract method of accounting in the construction industry went even further than the action taken by Congress in 1982. Following the tax committee mark-up of TEFRA in the Senate Finance Committee, then Secretary of the Treasury Donald T. Regan wrote to the TEFRA Conference Committee Chairman Robert J. Dole that "After further consideration I am concerned that the Senate provision dealing with the completed contract method of accounting is perceived to have an unnecessarily adverse impact upon the construction industry at this time". If Secretary Regan's recommendation had been acted on there would have been no change at all in the construction industry's use of the completed contract method of accounting.

Current Proposals

The House of Representatives and the Administration have recommended different proposals affecting the use of the completed contract method of accounting. Each of these proposals was reviewed and rejected by Congress in 1982. The House of Representatives' proposal (included in H.R. 3838) would repeal the completed contract method of accounting except that construction firms with under $10 million in annual gross receipts would still be able to use the method for contracts lasting less than two years. The Administration's proposal would apply the extended-period long-term contract cost allocation rules to all construction contracts.

House of Representatives' Proposal

The Ways and Means Committee, and subsequently the House of Representatives, approved tax legislation (H.R. 3838) which would repeal the completed contract method of accounting and require use of a modified percentage-of-completion method of accounting for long-term contracts entered into on or after September 25, 1985. Under the modified percentage-of-completion method, income would be reported during the life of the contract based upon estimated cost.

At the end of the contract, the actual income earned would be allocated to each year of the contract based upon actual costs, compared with the income reported under the percentage-of-completion method, and interest would be payable by, or to, the contractor on the yearly tax differences between reported income and allocated income (the lookback concept).

The House also adopted the Administration proposals which would apply the comprehensive cost capitalization rules now applicable to extended-period long-term contracts to all multi-year production, including long-term construction contracts.

However, in consideration of this legislation the Ways and Means Committee did recognize a number of the problems which these provisions would create in the construction industry. The House bill does exempt very small contractors, with average annual gross receipts of $10 million or less, from the new requirements and allows them to continue to use the completed contract method of accounting for contracts lasting less than two years.

This exemption does not go far enough, and the contractors who will be unable to use the completed contract method of accounting will face severe cash flow problems, be unable to continue their current work level due to bonding problems, be forced to furlough employees, and many will be forced to declare bankruptcy.

Administration's Proposal

The President's Tax Proposals for Fairness, Simplicity and Growth contain a proposal titled "Revised Rules for Production Costs" (Chapter 8.01) which would create a single set of capitalized costs for taxpayers performing long-term contracts, manufacturing inventories, self-constructing assets, growing crops and timber, and extracting minerals.

The Chapter proposes to implement the theory of 'tax neutrality' by applying the cost capitalization rules used for extended-period long-term contracts for tax accounting purposes to all of the multi-period activities just mentioned. The recommendation would have the effect of eliminating the construction contractor (less than $25 million in annual gross receipts) and construction

Pension and Profit Sharing Plan Contributions

The 1976 regulations specifically provide for a current deduction for amounts contributed to pension and profit sharing plans. The regulations clearly reflect the Code's provisions which determine the timing of the deduction for employer contributions to such plans. The Code provides employers a deduction for the amount contributed to the plans when the contribution is made even though employees do not recognize income until retirement.

To qualify for this deduction the employer must have a written plan which establishes the employer's obligations to the plan. As the Administration proposals do not recommend any change regarding the timing of deductions for contributions to plans in general, and tax policy continues to encourage the creation and funding of such plans, the rule for such deductions under the completed contract method of accounting should not be changed.

Bidding Costs

The 1976 regulations properly recognize that costs incurred in bidding on contracts are not contract costs. While bidding expenses must be incurred to win a contract they cannot be considered contract costs because there is no contract when they are incurred. Although these costs are allocated to extended-period long-term contracts due to some exceptional contract durations (for example, 10-20 years), any extension of the rule to ordinary long-term contracts cannot be justified.

Interest Expenses

Interest expenses are treated as a current period cost deduction under the 1976 regulations. The Treasury Department voluntarily dropped a proposal to require the capitalization of interest in 1982, yet the new reform proposals again recommend the capitalization of interest.

Interest is a fungible commodity which is not allocable to any contract. Contractors generally borrow funds on the basis of an overall working capital loan. Funds are used on projects as required. For example, if an owner has not made a progress payment when supplies for a project are purchased, funds from working capital are used. The funds may be used for a short period until the progress payment is made. Borrowed funds may also be used on projects where progress payments have been made. Allocating interest expenses in any rational manner in these situations is virtually impossible.

Requiring capitalization of interest expense is also grossly unfair. Any interest income earned as a result of the contract is treated as ordinary income earned currently under the 1976 regulations. For example, if a contractor receives a progress payment which does not require immediate expenditure, he may deposit it in an interest-earning account. Interest income generated by the deposited funds is recognized by the contractor as income immediately. It is unfair to require the contractor to pay tax on interest income and at the same time capitalize interest expense.

Each of these proposed changes to the completed contract cost allocation rules for construction were reviewed and rejected by Congress in 1982. Unlike a taxpayer self-constructing an asset, growing crops or timber, extracting minerals, or manufacturing inventory items, a construction contractor does not own the asset being constructed. There is simply no justification for requiring the contractor's accounting method to reflect the depreciation basis of a constructed asset owned by the customer. The contractor is actively engaged in a business activity and his income reporting method should be based on the income generated by the business. The rules developed by the IRS in 1976 recognize the business activities of the contractor and the policies which should be applied in developing an adequate and fair reporting method.

Proforma Company Example

The Associated General Contractors of America has prepared with accounting assistance an illustration of the impact of the Administration Proposals on a relatively small construction company using the completed contract method. The example is based on actual construction company tax and financial information. Construction contracts performed by the example company include building and road contracts.

In addition to the completed contract method of accounting provisions, proposed changes involving depreciation, investment tax credits, ACRS benefit recapture and corporate rate changes have been factored in to estimate the increased tax liabilities the company would incur under Administration proposals.

The most significant change in the first year of the proposed changes results from the acceleration of tax payments under the revised accounting rules for the completed contract method of accounting. Under present law the company has a taxable income of $264,248 and a tax liability of $91,524. Changes to the completed contract method of accounting increase taxable income by $331,859 bringing taxable income to $596,107. Taxable income rises even further to $625,698 when other provisions of the proposals are included. This 126% increase in taxable income attributable to the proposed changes in the completed contract method will be ameliorated over time as contracts close. However, the firm's working capital will be permanently reduced by the value of the accelerated tax payments.

The components of the completed contract changes discussed in the preceding sections of this paper comprise the $331,859 increase in taxable income. The rule requiring general and administrative expenses to be allocated to contracts comprises 53 percent of the increase in taxable income, or $174,801. The elimination of the deduction for excess tax depreciation over book amounts results in 4 percent of the increase, or $14,503.

A different mix of equipment or a different ratio of equipment to contracts can significantly increase this category's impact. The change in the treatment of profit sharing plan contribution deductions results in 8 percent, or $27,711 of the increase. Capitalizing bidding expenses on awarded contracts results in $60,109, or 18 percent of the increase. The interest expense capitalization requirement results in $54,735 of the increase, 16 percent of the total.

The other changes in the Treasury proposal result in a $29,591 increase in taxable income. When these increases in taxable income are subjected to the proposed new tax rate schedule and the elimination of the investment tax credit is also taken into account, the construction firm's year-end tax liability would increase from $91,524 to $237,026. The percentage tax liability under the Administration proposal over present law translates into a 259 percent increase.

Bonding Capacity

Another example developed by the Associated General Contractors of America will illustrate the impact which these accounting and tax changes have on the bonding capacity, and therefore the ability to accept contracts, of a typical construction firm.

COMPANY A

Company A has a deferred tax liability of $5 million, of which $2.5 million is payable at the end of its current fiscal year under the completed contract method. Company A also has a net worth of $6 million and working capital of $8 million. A bonding company considers net worth and working capital in determining the amount of work in progress it will permit Company A.

The bonding company also considers deferred taxes not to be paid in the current year as a reduction in current liabilities, thereby increasing working capital. In this instance, $2.5 million not due in the current year is deducted from current liabilities, increasing working capital by $2.5 million, from $8 million to $10.5 million. The bonding company will allow $20 of work in progress for each dollar of working capital.

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Under these circumstances, the bonding company will permit work in progress of $210 million ($10.5 million times 20). Under the percentage-of-completion method, however, Company A must pay an additional $2.5 million in income taxes, and the bonding company will in this case reduce the amount of work in progress allowed by approximately $50 million ($2.5 million times 20), or from $210 million to $160 million.

In a work program consisting of $210 million, work in progress, total operating revenue for a fiscal year would be in the range of $150 million. If the general contractor is doing 40 percent of the work with his own forces, the contractor would be employing approximately 800 employees. If the contractor's volume is thus reduced approximately 25 percent ($50 million divided by 210), then 200 of his 800 employees would become unemployed. Likewise, the approximately 1,200 subcontract employees would be reduced by 300 employees.

The reduction in the work force of the general contractor and of the subcontractor does not take into account the ripple effect on the hundreds of material and service suppliers to the general contractor and the subcontractor.

Conclusion

The completed contract method of accounting is the fairest and most equitable method of reporting income from long-term construction contracts because of the unique nature and inherent risks of construction. There is no justification for revising the present administrative rules for the method as they apply to the construction industry.

These rules were based on 58 years of IRS experience with the method when published in 1976 as final regulations and legislatively recognized by Congress in 1982. All current proposals to revise the use of the method in construction were reviewed in 1982 and rejected by either the Treasury or Congress as unworkable. They are contrary to sound tax policy and should be rejected once again.

Other Tax Reform Provisions

While the completed contract method of accounting proposals will have a serious adverse impact on individual construction firms, other tax reform provisions will severely harm both the industry and the nation's economy.

Accelerated Cost Recovery and Investment Tax Credits

The President's tax reform proposals recommend replacing the accelerated cost recovery system (ACRS) and investment tax credits (including credits applicable to real property improvements such as the rehabilitation and energy credits) with a new depreciation schedule called the capital cost recovery system (CCRS). The House-passed bill includes an incentive depreciation system, based on the old Asset Depreciation Range (ADR) mid-points, which would replace CCRS. Real estate under this system would be depreciated over 30 years, on a straight-line basis.

Under either of the proposed new depreciation systems, investors must wait a longer period to have their investment costs recognized by the tax system. The use of CCRS or the House's incentive depreciation system will have effects in other construction markets as well. Projects requiring extensive equipment installations will suffer more than those where the structure is the primary subject of the contract. The loss of the ITC will affect the cost of the equipment to be installed and is the difference between present law and the proposed changes. The proposed depreciation changes are expected to adversely influence investment decisions.

AGC's Proforma Co. example incorporates the changes to equipment depreciation and loss of the investment tax credit. While the Administration's proposal would increase the depreciation amounts for equipment by $3,418 (a benefit to the taxpayer), the loss of the investment tax credit increases the taxpayer's actual tax by $9,780. In addition, the benefit of acceleration would be curtailed by the change in accounting rules proposed for taxpayers electing the completed contract method of accounting by mistiming the deduction for the excess tax depreciation over book amounts.

Cash Method of Accounting

The Administration proposal proposes to prohibit the use of the cash method of accounting with respect to a trade or business unless both of the following conditions are met:

(1) the business has average annual gross receipts of $5 million or less; and,

(2) no other method of accounting has been used to determine income, profit, or loss of the business for the purpose of reports or statements, or for credit purposes.

The House-passed legislation contains the same essential provision, but eliminates the restriction in (2) mentioned above, allowing additional firms to continue to use cash accounting. The House legislation also exempts certain professional service corporations and partnerships from the restrictions on cash accounting.

Although the completed contract method of accounting is the dominant method used in the construction industry, cash accounting is also used. For example, engineering and architectural contracts are not eligible for completed contract reporting. Small firms, (exceeding $5 million in annual receipts) use the method as an election for all accounting purposes.

The cash accounting method is a fundamental accounting method and a necessity. It is simply unfair to restrict its use and put taxpayers in a position where they must pay tax on income before they receive the cash benefit of that income.

Foreign Tax Credit

The original Treasury Department recommendation to impose a per country limitation on the foreign tax credit (FTC) is reproposed in the Administration's tax proposals. The carryover period is proposed to be extended from 5 to 10 years. No change in the FTC carryback period of 2 years is proposed, despite the explicit acknowledgement in the proposal that an extension is reasonable. In addition, new income "sourcing" rules are proposed in the President's report to deal with the foreign technical assistance tax problem found in international construction. A per-country election to either deduct (when there is no foreign income) or credit foreign taxes is also proposed.

The House-passed legislation would tighten rules for foreign-source income from current law, but modifies the Administration proposal. The House limited the amount of income "switching" which could be done from high-tax to low-tax countries.

U.S. contractors compete in countries where they are able to win contracts; the location of job sites cannot be chosen for tax planning purposes and any restrictions on offsets for taxes paid in countries where jobs are performed cannot be justified.

Limiting Travel and Expense Deductions

The Administration proposes treating travel assignments extending beyond one year as "indefinite", thereby denying any travel deduction for such job assignments. This proposal would reverse a recent IRS ruling which extended the possible time for "temporary" job assignments to two years under a variety of safeguards. These safeguards are requirements which are not applicable to the traditional test of a temporary assignment.

AGC believes the present IRS rules for determing whether a job assignment is temporary or indefinite reflect the business realities of the construction industry and should be maintained. Both management and labor construction personnel are required to travel to job sites. These sites are frequently long distances from employees' homes and assignments can be for substantial periods. These living expenses are incurred as a result of the employees' income generating activities and would not have been incurred absent the business necessity. The proposed rule would unfairly treat these expenses as personal when the employee is already paying the expenses of maintaining his real personal residence.

Fringe Benefits

The President's report recommends including the first $10 per month and $25 per month of individual/family health plan coverage in an employee's gross income. The present $5,000 exclusion for employer provided death benefits would also be repealed. Uniform nondiscrimination rules are also proposed to cover a wide variety of employer provided benefits such as life insurance, health benefits, and educational assistance programs. New limits on contributions to cash deferred compensation plans would be imposed if individual retirement account contributions exceed certain levels.

The House of Representatives chose not to tax the health-related fringe benefits, and generally took a more sensible approach to the taxation of fringe benefits by recognizing the value of continuing present policies. AGC believes the policy of encouraging the creation of employer sponsored fringe benefit programs is better reflected by present law than the proposed Administration changes.

Municipal Bonds

The President's report recommends the elimination of the tax-exempt status of interest earned on bonds issued by state and local governments for "private purposes". These bonds are typically used to finance housing, transportation, commercial and industrial development within the bond issuing jurisdiction. Municipal bonds would lose their tax-exempt status if more than 1 percent of their proceeds are used directly or indirectly by any person other than a state or local governemnt. An exception is provided if the facility is used by the general public.

The House-passed legislation made a number of improvements to the President's proposal by creating a nongovernmental category which will still be eligible for tax-exempt financing, although subject to severe volume limitations. The House version is a major improvement over the Administration's proposal in that the importance of publicly-utilized facilities such as airports, ports, wastewater treatment, water supply facilities, and other capital investments are recognized, even if partially financed by private entities.

The Associated General Contractors of America has done substantial research into the problems of this nation's deteriorating infrastructure of public facilities, as has the Congressional

Budget Office, the Joint Economic Committee, and many other knowledgable organizations. All have concluded that the shortfall in infrastructure investment is at crisis proportions. With public spending coming under increasing budgetary pressures, revisions in the tax code which will further hinder the ability of state and local governments to find solutions to their infrastructure problems must be avoided.

State and Local Tax Deductions

The President's proposals recommend that the deduction for state and local taxes not incurred in a trade or business be repealed. These taxes include state and local real and personal property taxes, income taxes and general sales taxes. The reason given for the proposal is to eliminate any "federal subsidy" for local public services such as public education, road construction and repair, and sanitary services.

The House-passed legislation retains the deductibility of state and local taxes. AGC believes the deduction for state and local taxes is based on sound tax policy considerations. AGC has great concern that the repeal of state and local tax deductibility will prevent necessary investment in state and local infrastructure.

Possessions Tax Credit (Section 936)

The Administration's proposal adopts a Treasury Department recommendation that will dramatically affect construction activities in U.S. possessions, particularly in the Commonwealth of Puerto Rico . The House-passed legislation retains the credit while tightening the active trade or business test and cost-sharing rules.

The possessions tax credit (Section 936) has provided significant impetus to local economies in U.S. possessions. The substitute wage credit in the Administration proposal fails to compensate for the credit's repeal. AGC believes that repeal of the credit would have dramatically negative effects on construction activities in the U.S. possessions.

Capital Gains

The Administration's proposal to reduce the current capital gain exclusion from 60 to 50 percent is an improvement over the original Treasury Department recommendation to eliminate all capital gains. However, AGC is concerned about the restrictions on capital gain eligibility. Property used in an active business is not eligible for the exclusion unless the asset is land. These restrictions will prevent investors in limited partnerships from obtaining capital gain treatment on the sale of structures. Limited partners are owners of the property held by the partnership but do not have active management rights. This clearly distinguishes them from owners of active businesses.

The House-passed legislation would also reduce the current capital-gains exclusion from 60 to 50 percent in 1986, to a 42 percent exclusion thereafter, and would repeal the lower rate for corporations. AGC opposes these proposed changes in the tax treatment of capital gains, and believes that they will significantly harm capital formation.

At-Risk Limitations

The Code's at-risk rules have never been applied to investments in real property. Under current law investors in real estate syndications are allowed the full depreciation benefits of the cost of a structure without regard to the recourse liability of mortgage notes. Investors in personal property are subject to maximum depreciation amounts based on their personal liability under the at-risk rules.

This difference in treatment prevents valuation manipulations which can occur under a variety of situations in personal property investments. Such value manipulations are not applicable to real estate investments since they can be accurately valued. The imposition of the at-risk rules to investments in real property in the Administration proposal will require investors to assume liabilities which are not required for business ownership purposes and significantly reduce the attractiveness of investments in real property.

The House-passed legislation would include most of the Administration's proposal, but would exempt third-party financing. This is a major improvement over the Administration proposal.

Interest Expense Limitation

The President's Report proposes to limit all personal interest deductions, except for mortgage interest deductions for a personal residence, to $5,000 per year over investment income. Interest subject to the investment interest limitation includes: (a) all interest not incurred in connection with a trade or business, (b) the taxpayer's share of all interest expense of Subchapter S corporations unless the taxpayer actively participates in the corporation, and, (c) the taxpayer's distributive share of interest expense from limited partnerships.

The House-passed legislation would allow the deductibility of interest for both primary and secondary residences. This is a definite improvement over the Administration proposal, and AGC supports this modification.

Corporate and Personal Minimum Taxes

The Administration proposal included a tightened 20 percent Alternative Minimum Tax (AMT) on both corporations and individuals to replace the current add-on minimum tax. Of far more importance to the construction industry, the House-passed legislation contains an alternative minimum tax at a 25 percent rate with many additional preference items.

The most significant change in the House legislation is that the use of the completed contract method of accounting is not allowed for computation of the minimum tax. Instead, a taxpayer is required to apply the percentage-of-completion method in determining the minimum taxable income relating to a particular contract. The preference is calculated by substituting the minimum tax treatment for the regular tax treatment before calculating the minimum tax. In the House bill, this provision only applies to the small firms of under $10 million in gross receipts which were exempted from the repeal of the completed contract method of accounting.

The minimum tax proposal included in the House-passed legislation would greatly harm small firms without justification. Making the completed contract method of accounting a preference for purposes of the minimum tax takes away 70 percent of the usefulness of this method of accounting for construction companies subject to the minimum tax, according to an independent study by a major accounting firm. The completed contract method of accounting is a legitimate method of accounting, not a preference item, and its use should not be unfairly penalized by being made subject to the minimum tax. AGC strongly opposes this provision.

Solid Waste/Mining Reclamation Costs

Expenses that will be incurred in the future cannot generally be deducted currently, even if the existence of the liability can be established with certainty. Cash method taxpapers deduct expenses when paid. Accrual method taxpayers accrue expenses when economic performance giving rise to the expense occur.

However, pursuant to a statutory exception to these general rules to the economic performance requirement, taxpayers may take current deductions associated with certain mining and solid waste disposal site reclamation and closing costs. These amounts are added to a reserve account. After reclamation activities are concluded actual costs are compared with reserve costs and any additional costs are deducted or excess reserve deductions added back to income. These special rules lower the cost of these special activities. The proposed repeal of this rule will result in a corresponding increase in costs and disincentive to invest in such needed activities.

Summary and Conclusion

- The current proposed changes to completed contract reporting for construction were fully reviewed by Congress and rejected during the legislative process preceding the enactment of the Tax Equity and Fiscal Responsibility Act of 1982, and must again be rejected.

- Because of the beneficial ripple impact of construction throughout the entire economy, it is a certainty that any changes in tax laws that adversely impact the construction industry will surge throughout the entire economy with rippling adverse impacts on other industries that are dependent on the good health of the construction industry.

STATEMENT ON
THE TREATMENT OF CHARITABLE GIFTS OF APPRECIATED PROPERTY
IN THE INDIVIDUAL ALTERNATIVE MINIMUM TAX
IN H.R. 3838

SENATE COMMITTEE ON FINANCE

February 3, 1986

STATEMENT TO SENATE COMMITTEE ON FINANCE

I. Introduction

The Alliance for Philanthropy, a coalition of individuals, organizations, and institutions interested in the treatment of charitable giving under federal tax law, is pleased to have this opportunity to present its views on the alternative minimum tax provisions of H.R. 3838.

II. Summary

H.R. 3838 acknowledges the importance of charitable contributions by making permanent the charitable deduction for nonitemizers. Nevertheless, H.R. 3838 also includes provisions that are harmful and unnecessary departures from the federal government's historic stance of encouraging through the tax code charitable giving for public purposes. It imposes a $100 floor on the charitable deduction for nonitemizers and includes (to the extent of other preference income) the appreciated portion of gifts of appreciated property as a tax preference item in the alternative minimum tax (AMT). Since the subject of this hearing is the alternative minimum tax, this statement will focus on the treatment in H.R. 3838 of charitable gifts of appreciated property under the AMT.

Gifts of appreciated property have played an important part in the creation and are crucial to the continued operation and effectiveness of many of this country's most important institutional resources -- colleges and universities, social welfare organizations, museums and performing arts organizations, reli gious institutions, community foundations, and land trusts and related institutions, among others. The tax treatment of appreciated property gifts in H.R. 3838 would needlessly impair the ability of private philanthropy to continue to serve public purposes and to meet public needs.

This provision in H.R. 3838 will significantly harm charitable giving and the public purposes it serves without making a contribution towards a simpler. more efficient, or fairer tax system.

- It will reduce gifts which are essential to the success of major fund drives for facilities, equipment, and programs for colleges and universities, hospitals, museums and the performing arts, and religious, social welfare, and community organizations. It will hinder campaigns for endowing scholarship funds and community foundations, instituting research programs, and creating public-private partnerships and other innovative initiatives to harness private resources and energies to serve public purposes. It will adversely affect the operation of nonprofit land trusts which preserve ecologically and historically important acreage for future generations.

- It will encourage taxpayers to retain appreciated assets for private purposes, deferring indefinitely any tax on the unrealized appreciation, rather than contributing them to charitable institutions chartered under law to serve defined public ends.

- It is not necessary for an effective minimum tax. Deductibility for such gifts is already limited to 30% of adjusted gross income (AGI) per year. Moreover, the available evidence from over a decade of economic studies suggests that such treatment as is contained in H.R. 3838 will reduce charitable giving by more than it will increase tax revenues, thus actually reducing the amount of private and public resources allotted to serve public purposes. It is estimated that this provision will reduce giving by about $560 million per year and increase tax revenues by only about $330 million.

H.R. 3838 will also adversely affect charitable giving simply due to the lowering of tax rates. This is an unavoidable indirect consequence of reducing marginal tax rates and gives charitable institutions no cause to complain. But we believe there is no compelling rationale for any provision, such as the treatment of appreciated property in the AMT in H.R. 3838, that directly weakens the role of the charitable deduction in the tax code.

III. Importance of Gifts of Appreciated Property

The American system of taxation is unusual in providing incentives for private citizens to donate personal assets to provide community services and serve public purposes. By allowing a deduction for charitable contributions, including gifts of appreciated property, the federal income tax code has, since its inception, recognized the importance of charitable giving as an efficient decentralized mechanism for engaging the energies and resources of millions of citizens in initiating actions and providing services of enormous benefit to the public.

In 1981, Congress continued to make contributions fully deductible under the alternative minimum tax as well as the regular income tax. The charitable deduction was also gradually extended to all taxpayers for a five-year period. In so doing, Congress again acknowledged the importance of charitable contributions as an effective mechanism for meeting public needs.

The charitable deduction provides a mechanism parallel and complementary to the system of taxation and appropriations -- one particularly well suited to the diversity of the nation, and to our tradition of local voluntary action for identifying and serving community and national needs. It also supports activities and services of recognized public value which the government is precluded from providing or which are better provided privately.

Thus, our educational, health care, social welfare, religious, community, and cultural institutions have come about not through government appropriations alone, as in most other countries, but through unique and appropriate combinations of public and private contributions. According to Treasury statistics, Americans who itemized charitable deductions donated approximately $37.5 billion to support charitable activities in 1983. Of this amount, approximately $5.3 billion was contributed in the form of appreciated assets, which under current law are fully deductible up to a limit of 30 percent of AGI.

It is widely understood that universities, museums, performing arts organizations, hospitals and other charitable institutions -- with large capital needs for facilities construction, equipment purchases, collections, and research -- have been the beneficiaries of gifts of appreciated assets. It is perhaps less widely known that gifts of appreciated assets are essential to the founding and operation of community trusts, which are increasingly important self-help institutions by which communities can address local and regional problems; of land trusts, which preserve lands for environmental and recreational purposes; of trusts for historic preservation; and of many other charitable organizations effectively and efficiently providing public services.

Gifts of appreciated property play a particularly important role in the fundraising efforts of these institutions. These gifts set the pace for capital fundraising efforts and attract additional private financial support. These leadership gifts often take the form of "challenge" grants, a promise to give the institution a certain amount of money if it can raise twice or three times that amount from other sources. The challenge grant is frequently in the form of appreciated assets. This gift attracts smaller donations, in cash or appreciated assets, and enables an institution not only to meet the challenge but to expand its base of support.

Such grants have been widely used by charitable institutions to build buildings and increase endowment funds. Colleges and universities have used them as well to endow scholarship funds, professorships, and academic programs. In the absence of federal appropriations for construction or renovation of academic buildings and laboratories, private fundraising, in which gifts of appreciated assets will play a crucial role, is an important way colleges and universities can deal with the critical problem of renewing their aging physical facilities, a need estimated at over $50 billion nationwide.

IV. Importance of the Private Sector in the Current Economic Climate

The House proposal to tax gifts of appreciated property in the AMT will handicap the private fundraising efforts of nonprofit organizations at the same time that deficit reduction efforts are aimed at reducing the amount of direct federal support for domestic programs. Under the President's budget proposal, universities face cuts in student aid appropriations and in reimbursement for indirect costs of research. The Institute for Museum Services is proposed for elimination. The budgets of the National Endowment for the Arts and the National Endowment for the Humanities are slated for cuts of about 12 percent. Hospitals face proposed changes in reimbursement mechanisms which further reduce the extent to which costs can be recovered. The termination of a number of social service programs is proposed to assist deficit control efforts in subsequent years.

Given the effect of these and other deficit control proposals, this is no time to reduce an efficient incentive for the private sector to support independent institutions which have traditionally shared responsibility in these areas with government.

V. Efficiency and Fairness of the Deduction for Appreciated Property Gifts

The charitable deduction is efficient. The Joint Committee staff paper on comprehensive tax proposals released in mid-1985 stated that while other factors also motivate giving, "the preponderance of evidence suggests that the itemized charitable deduction has been a stimulant to charitable giving, at least for higher-income individuals."

The evidence from the studies referred to earlier in this statement support this conclusion that the charitable deduction is efficient. For changes in tax law which encourage charitable giving, the increases in giving will be larger than the decrease in tax revenues. Conversely, for changes in tax law which discourage charitable giving, the decrease in giving will be greater than the increase in tax revenues.

This means that by simply changing H.R. 3838 to reflect current law with respect to the treatment of gifts of appreciated property, the Senate Finance Committee can increase charitable giving by $560 million at a cost of $330 million in tax revenues, thereby increasing by a net of $230 million the total public and private resources allocated to public purposes. This simple change in H.R. 3838 would generate almost $1.70 in public benefits for every $1.00 of tax revenue foregone---a significant bargain and evidence of the efficiency of the charitable deduction for appreciated property.

The deduction for gifts of appreciated property is a particularly effective way to encourage the donation of private wealth to support public activities. H.R. 3838, however, creates a situation in which there is substantially less incentive for a taxpayer to give a gift to public purposes rather than keep it for his own use during his lifetime and then pass it on to his heirs. The effect will be that the property will be retained by wealthy individuals rather than being made available for public use.

Continuing current law would not compromise the purpose or effectiveness of the alternative minimum tax. Because annual deductibility for gifts of appreciated property is limited in current law to 30% of AGI per year, no high income taxpayer can reduce taxable income to zero solely because of charitable gifts of appreciated property. Moreover, most other steps taxpayers take to minimize or escape taxation lower AGI as well, thus reducing the allowable deduction for charitable gifts of appreciated property (or cash) as well. Finally, an August, 1985 Treasury study for the Ways and Means Oversight Subcommittee indicated that itemized deductions were not important causes in allowing high income taxpayers to escape taxation.

It is also true that the charitable deduction is significantly different from any other tax preference item in the AMT in that it represents an actual donation of assets. After making a donation, even with the tax deduction, a taxpayer always reduces his net worth.

Finally, it is important to note that the matter of ensuring correct valuation of gifts of appreciated property is a separate issue. To ensure that the amounts deducted for property donations reflect actual value, the Congress enacted provisions (and strengthened penalties) in 1984 requiring that valuation be substantiated either by qualified appraisals or by reference to publicly listed price quotations.

VI. Conclusion

Current law treatment for charitable gifts of appreciated property should be maintained. Such gifts should continue to be fully deductible, subject to current percentage of AGI limitations, under both the regular income tax and the AMT; such gifts should not be an item of tax preference.

Appreciated property gifts are important to the success of major fundraising campaigns of virtually every charitable organization. They are leadership gifts. Current treatment of charitable gifts of appreciated property is a bargain and should be continued.

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Thomas E. Thomason
Vice President

February 12, 1986

Senate Finance Committee
SD-219 Dirksen Senate Office Building
Washington, D.C. 20510

ATTN: Betty Scott-Boom

Subject: Alternative Minimum Tax Proposals
House Bill (HR 3838)

Dear Ms. Scott-Boom:

We wish to take this opportunity to submit our written comments (five copies) on the Alternative Minimum Tax (AMT) proposals included in the house-passed Tax Reform Bill (HR 3838) for inclusion in the Senate Finance Committee hearing record.

The House-passed Tax Reform Bill contains a number of provisions which would have a detrimental impact on the ability of U.S.-owned international service businesses to compete in foreign markets. The purpose of this letter is to focus on one provision which particularly affects international service companies, such as Bechtel, which employ significant numbers of U.S. citizens overseas. This provision is the proposal to treat the Section 911 foreign earned income exclusion as a tax preference item, subject to the new 25% AMT.

The proposed treatment of the Section 911 exclusion as a tax preference item subject to the AMT is inconsistent with the intent of Congress when it enacted the Section 911 exclusion and increased the annual exclusion amount in 1981. In HR 3838, the House recognized the importance of retaining the Sec. 911 exclusion in the tax law, albeit at a somewhat reduced amount, in order to enable U.S. businesses to compete in the international marketplace. However, by making Section 911 excluded income subject to the ATM, the House Bill would take away a significant portion of the Section 911 incentive.

This contradictory provision is also inconsistent with U.S. trade policy, which is concerned with the deteriorating U.S. balance of payments and trade situation. It would increase the cost to U.S. employers of employing Americans abroad in their foreign operations. Also, it is a short-sighted proposal, in direct conflict with the country's need to enhance its international trading position.

The proposal to subject the Sec. 911 exclusion to the AMT would result in a significant increase in the cost of our services, posing a serious threat to our competitiveness in overseas markets. We estimate that this change would result in an increased cost to our company of between $5-10 thousand annually per overseas U.S. employee under the company's tax protection program.

Therefore, we strongly urge your Committee, in its consideration of the AMT proposals in HR 3838, to delete the ill-conceived proposal to treat the Section 911 exclusion as a tax preference item, since it is inconsistent with Congress' intent in establishing the Section 911 exclusion, contradictory to the House Bill's retention of the exclusion, and detrimental to the U.S. balance of payments and international trade.

Sincerely,

Thomas E. Thomason
for

Thomas E. Thomason

TET/MEL: fkc
ML374

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A California Non-Profit
Tax-Exempt Corporation

February 13, 1986

1986 [illegible]

Ms. Betty Scott-Boom
Committee on Finance S.D. 129
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Committee Members:

The Big Sur Land Trust would like to express deep concern over the alternative minimum tax proposal, as part of the Tax Reform legislation currently before Congress.

Since our incorporation in 1977, The Big Sur Land Trust has completed 22 land transactions that effectively preserve 5,150 acres along the California coast. These properties are mostly in the viewshed, that is, the scenic panorama as seen by over 3 million people per year traveling Highway One.

The beauty of this coastal area is world renown, but few realize that 75,000 acres of the scenic viewshed is privately owned. The high public and private desirability of this landscape has resulted in high property values, making most properties prohibitive for public acquisition. The Big Sur Land Trust was formed to fill this gap between the private and public sectors by providing various techniques and financial incentives to encourage private landowners to preserve their properties for public conservation purposes.

The proposed alternative minimum tax proposal would, without a doubt, reduce gifts of land in our area with the results being the diminishment of this scenic area by development or the threat of such would increase the public's demand for expensive public agency acquisitions.

Specifically, we can look back on completed transactions and estimate, based upon knowledge of our donors, that at least 13 transactions totaling 3,085 acres would not have been made available had these donors been subject to the AMT proposal. We would expect the same results in many parts of the country.

Going beyond the effects on land conservation, the proposed AMT change would undermine the work of all public charities that depend upon the donation of appreciated assets for their support. To reduce their effectiveness runs contrary to the President's repeated philosphy of encouraging the private sector to do the work of government. We feel passage of the proposed AMT will do just the opposite by creating a necessity for increased government funding.

In summary, the existing AMT is best left alone if private philantrophy is to be maintained unless the consequence of increased federal spending can be accepted.

Sincerely,

Brian Steen

Brian L. Steen
Executive Director

BLS:k

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WRITTEN STATEMENT

Ira H. Shapiro
Director of Tax Policy
Coopers & Lybrand

Hearings Before the Senate Committee on Finance
U.S. Senate
February 3, 1986
on the
Corporate Minimum Tax

Mr. Chairman and Members of the Committee, I am pleased to provide our analysis to the Committee on the proposed changes to the corporate minimum tax now before the Congress, as contained in the House-passed tax bill, H.R. 3838. We submitted testimony to the Committee last fall which assessed these provisions of the President's plan and the House Ways & Means Committee staff option. This statement focuses only on the corporate minimum tax in the House bill. I am submitting this statement on behalf of my firm, Coopers & Lybrand, an international accounting firm.

We selected the corporate minimum tax issue for purposes of our analysis and testimony before the Congress because we see it as a provision that can have significant effects on corporations and yet is in danger of receiving insufficient attention when the focus of the debate is on the larger questions of tax reform. Thus, we hope that our analysis of the issues involved in these proposals for a corporate alternative minimum tax (AMT) will assist the Committee in addressing this area in a more comprehensive and deliberative manner.

In a sense, it is unfortunate to have to address the issue of a minimum tax because, as a policy matter, a minimum tax is an admission of failure in the design of the tax system as a whole. It says that we have provided incentives in the tax system to encourage certain actions, but we become alarmed if these incentives are used too successfully. Arguably, if "excessive" use of certain preferences is a concern, a better approach would be to limit the specific incentive. Then Congress could appropriately debate, in the context of the provision at issue, what maximum use should be permitted. Instead, the response to published reports that certain corporations have paid no tax has been, at least since 1969, to institute or revise the minimum tax. It has become, indeed, a predictable political response to the "tax fairness" issue.

Despite these political realities, it's important to note that a minimum tax should be, by nature and design, a limited response to the perceived problem.

- A minimum tax should not be used to raise significant amounts of revenue, and it probably cannot be designed to do so and remain a true minimum tax.

The House-proposed corporate alternative minimum tax (AMT) is a cause for concern in this regard. The present minimum tax on corporations raises about $500 million in revenue annually. The proposed AMT would triple the revenue impact of the corporate AMT and would do so by imposing a tax on a broad measure of income at a rate 25%, only 11 points below the regular corporate rate.

- A minimum tax is unlikely to affect the fundamental fairness of the tax system.

Given its uneven effects and often unpredictable interaction with the regular tax, it is not possible to systematically achieve better tax neutrality or tax equity, vertical or horizontal, through a minimum tax. Probably the best it can achieve is some assurance that all profitable companies (and individuals with some level of positive income) will pay a modicum of tax.

- A minimum tax, given its limited objectives, should not apply broadly to large numbers of taxpayers.

Otherwise, the minimum tax could become such a major aspect of the tax system that it would unduly complicate the system as a whole.

- A minimum tax should not apply retroactively to prior investment decisions.

A minimum tax that reduces the yield on investment decisions made and assets purchased in earlier years is insupportable. It certainly would not add to the real or perceived equity of the tax system.

Creation of Dual Tax Structure

Despite these basic premises which we believe should be observed in designing a corporate minimum tax, the AMT in the House bill is of such breadth and magnitude in its impact that it really is a mistake to think about it as a minimum tax at all. Rather, it establishes a dual tax structure with the AMT operating as a floor on corporate tax liabilities. To illustrate:

- It will require every corporate taxpayer to compute potential tax liability under both the regular tax and the AMT each year.
- Separate records must be kept for this purpose since the AMT mandates the use of another depreciation system (i.e., the Nonincentive Depreciation System) and in some areas, employs other accounting conventions that differ significantly from those used for regular tax purposes. Net operating losses would have to be computed and tracked separately for purposes of the tax since the AMT rules differ. The basis of assets would

differ for determining gain or loss on disposition, also as a result of the use of the Nonincentive Depreciation System.

- Potential liability under each tax would have to be tracked throughout the year in order to meet the new requirement that estimated tax payments include any AMT liability.

- The AMT would often apply to a corporation that seems to have no tax preferences. Under the proposal, credits could not be used to reduce the regular tax to an amount below the AMT; in effect the AMT is imposed in these situations. Affected corporations would be those with carryover investment or other tax credits (from pre-1986 years) and those earning any new credits that are permitted (such as R&D or rehabilitation tax credits). A similar effect would result for real property depreciated under the Incentive Depreciation System over 30 years, using straight-line amortization. Under the proposed AMT, a preference is created, even though there is no accelerated depreciation, because the nonincentive system requires a 40-year write-off period. Thus, 25% of all real property depreciation would be considered a preference item for AMT purposes.

We do believe that the proposals suggested by the House and the President are on the right track in shifting to an alternative minimum tax from the add-on tax. It has become increasingly apparent over the years that the add-on tax operated more often than not to increase taxes on companies already paying tax and that it was not effective in assuring that all companies with economic profits paid some level of tax.

Yet it must be recognized that when shifting to an alternative tax, it becomes even more crucial to design it well because of its potential for economic distortion and stimulating tax-motivated responses. These concerns are heightened when the proposed rate is as close to the regular tax rate as the House proposes. We believe there is a potential for the tax to encourage tax-motivated mergers in order to more fully use permitted tax benefits. An even more pervasive effect of the tax would be the extensive business planning required of all companies to minimize the tax consequences of investment decisions.

Coordination with Regular Tax/Use of Credits

Another improvement in the House bill is the carryover provision it contains in the form of an AMT credit. While not a perfect solution, it would mitigate some of the worst effects of an AMT and provide an averaging device for companies with more volatile earning patterns. In earlier testimony we had discussed the need for such a device, and a July 1985 Congressional Budget Office staff working paper also observes that "without such carryover provisions . . . an AMT would greatly increase both the reasons for and the complexity of tax-motivated business planning."

The CBO report goes on to observe that even with such a provision, other factors can cause the AMT to fall more heavily on one corporation than another. One such factor is the degree of unused preferences from prior years. Reliance on an AMT to act as a floor would mean that, for some companies, the value of unused tax incentives from prior years could be quite low. This effect is most obvious if one considers a company that expects to remain under the AMT indefinitely. In this case, the carryover credits -- as well as any new credits -- could never be used. In less extreme examples, the value of these "excess" incentives would depend on the timing of the AMT and how quickly the incentives can be used.

In the present context, explicit decisions should be made about the use of any tax credits retained under the reformed tax system, such as the R&D and rehabilitation tax credits, and about investment tax credits carried over from 1985 and earlier years. If taxpayers are not allowed to use their ITC carryovers against the AMT, particularly unwarranted effects may result. Some taxpayers may be prevented for several years from using their credits, a delay which devalues those credits significantly. Such a denial would have the effect of retroactively increasing the tax, and reducing the yield, on assets purchased in the past. It should also be noted, in terms of the potential effect of this provision, that ITC carryovers are currently concentrated in manufacturing (85%), the sector that would be most adversely affected by other changes in the bill which increase the cost of capital.

If the Committee feels that some limit is necessary, we would suggest that the overall limit on credits as a percent of tax liability also be applied to the minimum tax.

Tax Base

The AMT option before you requires careful consideration of the proper tax base for a corporate minimum tax. At the outset it's good to keep in mind that this would be the first corporate alternative minimum tax. Thus we're setting out to define the concept of economic income for corporations and to determine the appropriate minimum rate of tax on that income. The right answers to these two basic questions are not self-evident, but rather will require the Committee's careful consideration.

Indeed there is great variability in the concepts used by different researchers to measure economic income, while another set of rules is suggested by the tax rules for E&P purposes, and yet another by generally accepted accounting principles. A good example is the variability in permitted depreciation of assets -- does a building last 30, 35 or 40 years? Or take the treatment of R&D expenses which must be written off currently for accounting purposes and may be deducted for tax purposes today. What's the right treatment? The answer will govern whether a company has economic income as well as determine how much income should be subject to minimum tax. These questions are not esoteric ones, to be resolved later as refinements are made, but are basic to the application of such a tax to corporations.

The importance of this conceptual difficulty is heightened because the current proposals would not just tax income that is presently excluded for regular tax purposes, but would also accelerate the time at which tax is paid in many instances. The treatment accorded accelerated depreciation and receipts from long-term contracts illustrate this point.

The provisions of the House bill should be carefully studied in this context, and your decisions about how to define minimum taxable income should be tempered by weighing the importance of the change with the resulting complexity. For example, if the depreciation system adopted for regular tax purposes is not a greatly accelerated one, how important is it to require a totally separate "nonincentive" depreciation system for AMT purposes?

We do endorse the decision of the House Ways & Means Committee to exclude R&D expenses from the list of corporate tax preferences. The inclusion of R&D expenses as a corporate preference and, thus, as an additional item of economic income is highly questionable. As noted previously, such costs must be expensed under generally accepted accounting principles. A particularly onerous result would be a substantial increase in the cost of venture capital for high technology start-up companies that do not have income for financial reporting or tax purposes and do not have positive cash flow. Furthermore, it may cause large, established high technology companies, already paying a relatively high effective tax rate, to pay substantially higher taxes. These companies may also find themselves in a permanent AMT position and not be able to benefit from the AMT credit carryover provision. In short, treating R&D as a preference would amount to a penalty on R&D activities that seems unwarranted as part of the tax reform objective.

Conclusions

To summarize, we would urge the Committee to consider in its deliberations on this issue the limited objectives that a minimum tax should serve in the tax system. Expecting it to accomplish too much would be a serious error. On the other hand, if a minimum tax could be devised that would appropriately address the perceived policy and political needs that remain after more basic decisions are made on the larger issues of tax reform, such a minimum tax might add importantly needed stability to the tax system as a whole.

We would caution that the design of an AMT must be studied even more carefully. Because of complex interactions with the regular tax structure, it is all too easy to develop a minimum tax that has unintended consequences on taxpayer behavior, is unduly complicated, or works against other policy goals that Congress has established. We have raised some questions of design and application of the House proposal that we hope will assist the Committee in its further consideration of a corporate AMT. While we concur with the House changes to the NOL provisions and the decision to provide a carryover mechanism, the base and rate of the proposed AMT require further study. As proposed, the AMT would apply very broadly and impose much additional complexity. We also urge the Committee to reconsider the extent to which credits can be used against the AMT.

Most importantly, the Committee must try to resist pressure to overreact -- to develop a corporate minimum tax that applies too broadly, to too many taxpayers, at too high a rate of tax. Such a result would add unwarranted complexity and unfairness to the system, rather than improving it.

We are operating from a basic premise that, whatever else is accomplished in tax reform, what is most needed is greater certainty and stability in the tax system. Since 1980, the Congress has enacted three major tax acts which have added in excess of 1,000 pages of statutory changes to the tax Code and another 300 regulations projects. The inventory of regulations projects is now in the range of 450. At the end of 1980, this inventory level was just over 200.

To the extent that annual tax changes of a structural nature are now stimulated because a few taxpayers have income but pay no tax, solving that problem is worth whatever effort it takes. In our view, the best justification for "tax reform," as well as for spending adequate time now on the minimum tax, is that the end result may mean less change and more certainty in the tax system as a whole. The goal should be to get it right and leave it alone.

THE DOW CHEMICAL COMPANY

STATEMENT ON THE EFFECT OF THE CORPORATE ALTERNATE MINIMUM TAX ON GROWING COMPANIES

By: Gilbert A. Harter

Submitted to the Senate Finance Committee

for the Written Record of Hearings

Held on February 3, 1986

THE DOW CHEMICAL COMPANY

STATEMENT ON THE EFFECT OF THE CORPORATE ALTERNATE MINIMUM TAX ON GROWING COMPANIES

By: Gilbert A. Harter

February, 1986

Although problems with the corporate alternate minimum tax as proposed in HR 3838 have been widely discussed, there has been little said about the significant impact it would have on growth companies. This minimum tax has the character of a tax on growth. The accompanying paper, How Tax Reform Would Affect Companies With Different Growth and Profitability Characteristics, shows that the corporate alternate minimum tax would fall most heavily on rapidly growing companies. These are the companies that are being counted on to create jobs, increase national output, and restore the trade balance. It would be poor policy to especially burden these companies.

High growth generally only follows after fixed capital spending and other spending to increase output has been high. In fact, growth is generally proportional to capital spending. With a minimum tax preference defined by the excess of accelerated depreciation over straightline depreciation, the amount (or likelihood) of minimum tax becomes a direct function of the rate of growth.

As defined in HR 3838, the personal property accelerated depreciation preference is very large; yet, it is hardly a true preference. Some acceleration of depreciation is necessary to reflect obsolescence, inflation, and decline of profitability with time; more rapid capital cost recovery than straightline depreciation over ADR life is necessary to reflect nonpreference real cost. HR 3838's accelerated depreciation preference eliminates accelerated depreciation for companies paying the minimum tax. Its effect is to impose tax on real cost and thereby tremendously increase the tax system's bias against saving and investment.

Not only does the accelerated depreciation preference broaden the proposed alternate minimum tax base excessively, but the high 25% tax rate compounds the damage. The high rate ensures that a large share of U.S. companies, perhaps a majority, would face minimum tax liability. For many, that liability would last for an extended period of time. Growing companies in particular would require substantial, sustained profitability levels to escape the minimum tax. A minimum tax should be an exception tax. This minimum tax would replace regular law as the primary determinent of tax liability for many companies.

In order to mitigate the above mentioned adverse effects on growing companies while retaining the basic minimum tax concept, the following modifications to HR 3838 are recommended:

1) redefinition of the accelerated depreciation preference as the excess of regular tax depreciation over straightline depreciation covering the same life,

2) reduction of the alternate minimum tax rate to 10%.

These changes would substantially reduce HR 3838's adverse effects on investment, competition, prices, and exports.

How Tax Reform Would Affect Companies With Different Growth and Profitability Characteristics

Gilbert A. Harter
Manager of Tax Economics
The Dow Chemical Company

January, 1986

Tax revision has been promoted as a way for the U.S. to encourage growth. Whether or not it would do so depends heavily on its effect on corporations. The House Ways and Means Committee Bill would increase the overall corporate tax burden by $139 billion over five years, yet its proponents argue that the bill would encourage growth because of the ten percent corporate tax rate cut. This would supposedly benefit the fast-growing companies on which economic growth primarily depends. Proponents discount the effects of reduced capital cost recovery and the minimum tax on the ground that these burdens would fall primarily on capital intensive, slow growth, low profitability companies which are less important to economic growth. The correctness of such assertions about the incidence of the corporate tax increase is a key question in the tax revision debate.

The analysis which follows sheds light on that question. It shows that increases to corporate tax burdens due to tax revision would be greater in rough proportion to each company's rate of growth. This would favor established companies and punish the growing companies which the U.S. should want to encourage. It also suggests that most companies would pay more tax under the proposed law than under current law and that a significant number of companies would face extended periods of minimum tax liability.

Analysis

Among those proposed tax changes which would impact most corporations, the most revenue important are:

corporate rate reduction
repeal of investment credit
slowed depreciation
reduced foreign tax credit limit(s)
expanded corporate alternate minimum tax

It is obvious that the capital cost recovery reduction is most burdensome to companies which are investing heavily and growing rapidly. Similarly, rate reduction is most beneficial to companies which are making lots of profit, that is, to high margin companies. This analysis, therefore, focuses on growth and profitability as variables. These variables both tie to the value of fixed assets in use. Growth[1] may be measured as the rate of increase in assets used. Profitability[2] may be measured as the ratio of pre-tax profit to assets used.

Tax burdens under current and proposed law were calculated for a range of cases representing simple, domestic companies. For modeling purposes, the companies were assumed to exhibit constant rates of real growth in sales, cash flow, and capital spending. Profitability was expressed as a function of fixed assets in use. Detailed bases and an explanation (Appendix I) of capital cost recovery effects are attached.

Figures A, B, C, D and E show current law and proposed law tax burdens as a function of profitability at a number of real growth rates. Note that the section of proposed law tax line to the left of the inflection point is controlled by the minimum tax. Figure F shows tax burden threshholds as a function of growth. Tax burdens for the case calculations are tabulated in Table I.

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[1] Growth is achieved by the increasing investment. With constant profit margins and no inflation, the rate of growth equals the excess of investment over real depreciation divided by total assets at cost. When inflation is present, both assets and depreciation are understated, and the rate of real growth is less than shown by the above ratio.

[2] Accounting profit is defined net of some allowance for depreciation. Nine year straight line depreciation was assumed for this analysis. True economic depreciation must be somewhat greater to reflect inflation and the declining profile of cash flow. Profitability, thus slightly overstated, is shown as a function of the replacement value of assets.

Table II contains single year profitability and growth references for a few randomly selected companies for which published data was readily available. These references are also plotted on Figure F. The individual company data is useful as a general indicator of where companies might fall on the curve, but due to time and information limitations is very crude. For example, it does not eliminate the effects of foreign operations. In addition, the use of single year data can be misleading. Average growth and profitability over a number of years would produce a better reference. Comparative growth and profitability figures by industry would also have been helpful but are not easily obtained; two digit SIC codes are too broad to be meaningful.

Commentary:

(1) Corporate taxes for most companies would be greater under proposed law than under current law. Average pre tax manufacturing profit runs only about eight percent of fixed assets at replacement. With national investment increasing by more than three percent p.a.

in constant dollars, companies would face increased tax unless substantially more profitable than the eight percent average. See Figure C. Note that the reference companies shown are generally more successful and profitable than average.

The key determinant is the ratio of fixed capital spending to profit. Capital intensive companies tend to have high ratios of fixed capital spending to profit, but only if continuing to expand. Companies not investing in fixed assets (e.g. trading companies) would simply gain from rate reduction. Companies with typical fixed asset requirements would generally gain less from rate reduction than they would lose from reduced capital cost recovery. Only slowly growing or declining companies with high ratios of pre-tax profit to fixed assets would be exceptions. See Figure F.

(2) More rapidly growing companies would be particularly hurt by the proposed tax changes. See Figures C, D and E for amounts. Their tax increases would include minimum tax unless their profitability should be quite high. Current law properly defers the time of substantial tax payments until growth declines and cash flow turns positive. The proposed changes would force growing companies to borrow to pay taxes.

(3) The proposed corporate alternate minimum tax has the character of a tax on growth. Defining the excess of accelerated depreciation over unindexed straightline depreciation as a preference item ensures this. Furthermore, the high, 25 percent minimum tax rate and the inclusion of regular taxable income in the minimum tax base means that substantial profitability levels are necessary to escape minimum tax. See Figure F and the inflection points on Figures A, B, C, D and E.

(4) Many corporations would face extended periods of minimum tax liability. If so, even the fairly modest benefits of the proposed accelerated depreciation schedules and of foreign sales corporations would be largely lost.

(5) In addition to slowing economic growth, the proposed reform would be anticompetitive. Growing companies tend to spend whatever their cash flows will allow. Substantially increasing taxes on lower margin growth companies would constrain their abilities to expand and compete with established high margin companies.

(6) Although the real cash flow impact of tax reform would be substantial, the reported impact on corporate profits would be less inasmuch as bookings of deferred tax would decline.

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FIGURE A

COMPANY GROWING -3% PER YEAR
(INVESTING 81/1000 EQUIPMENT CAPITAL)

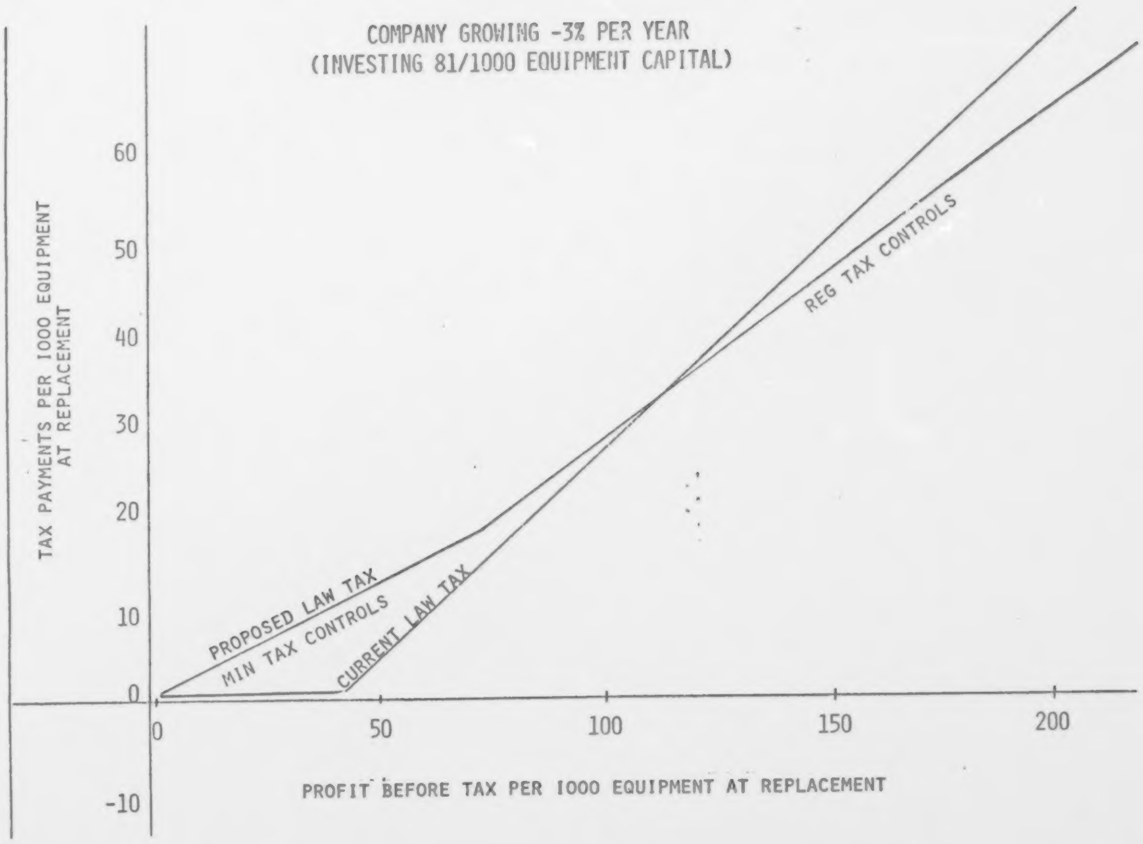


FIGURE B

COMPANY GROWING 0% PER YEAR
(INVESTING 111/1000 EQUIPMENT CAPITAL)

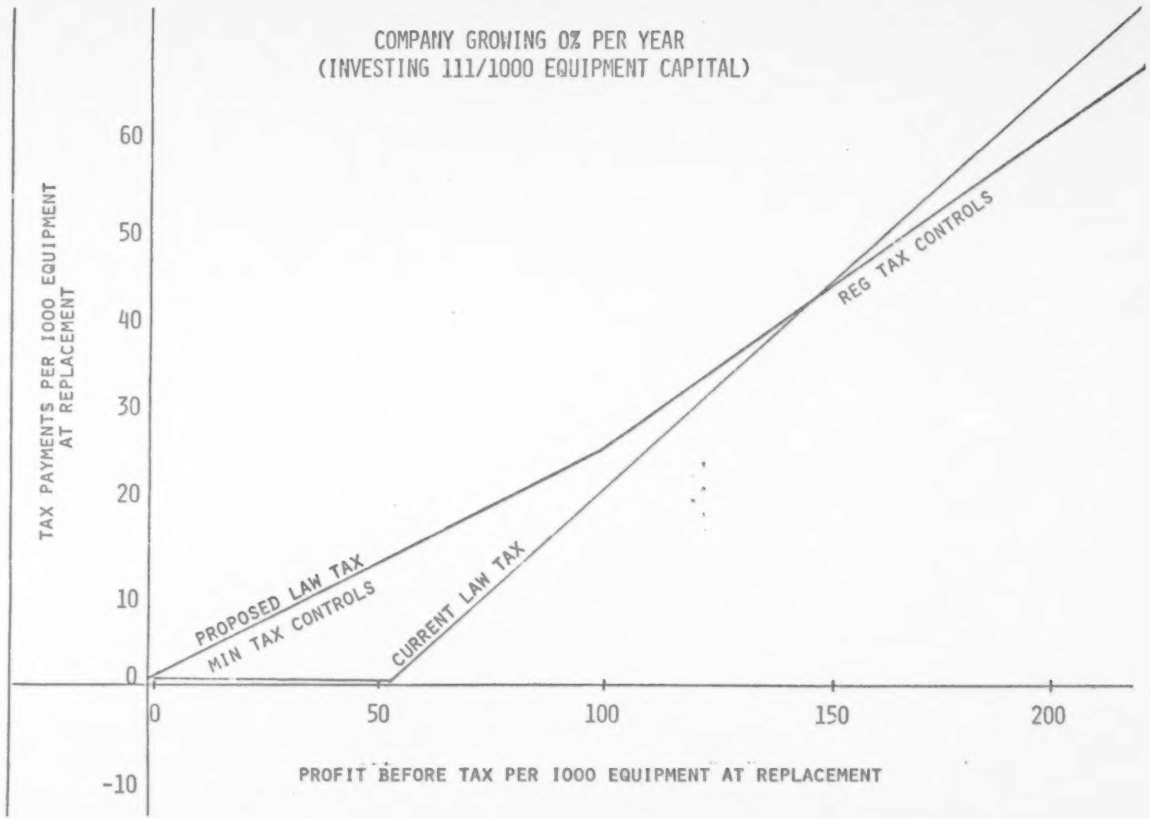


FIGURE C

COMPANY GROWING 3% PER YEAR
(INVESTING 141/1000 EQUIPMENT CAPITAL)

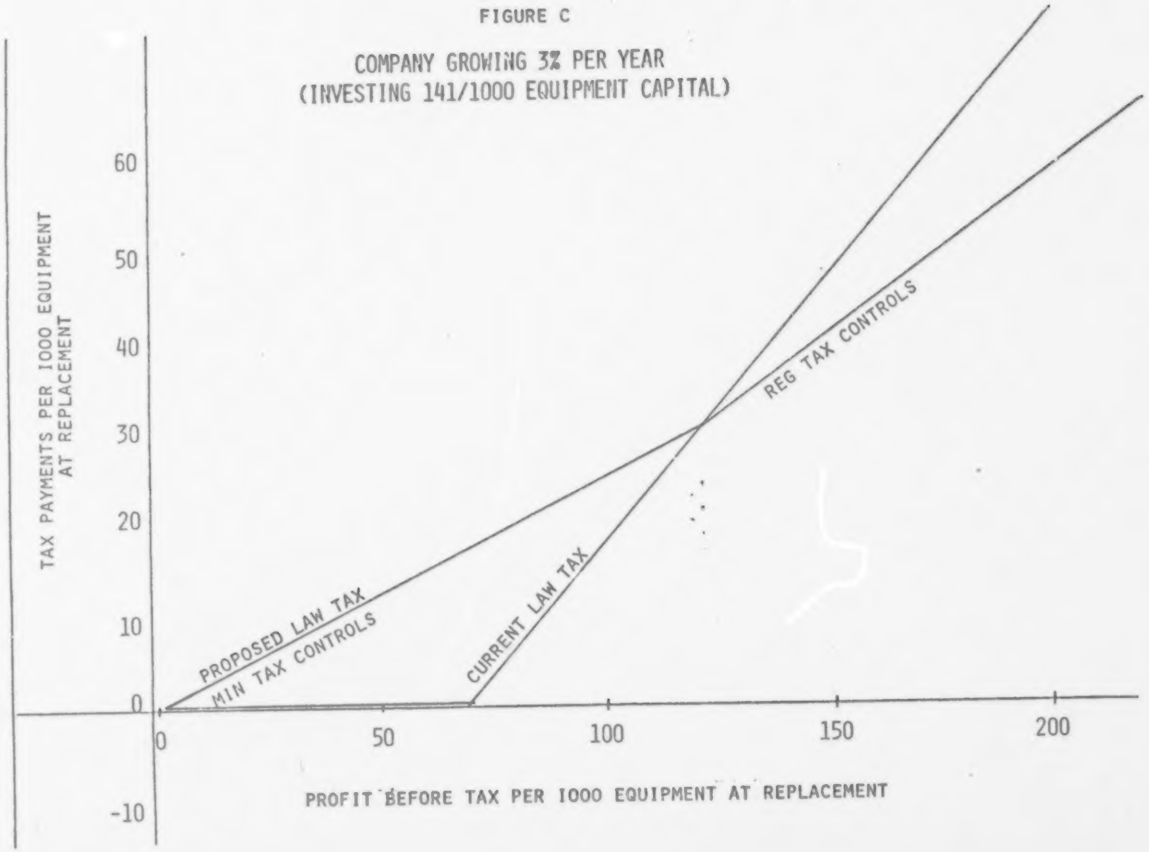
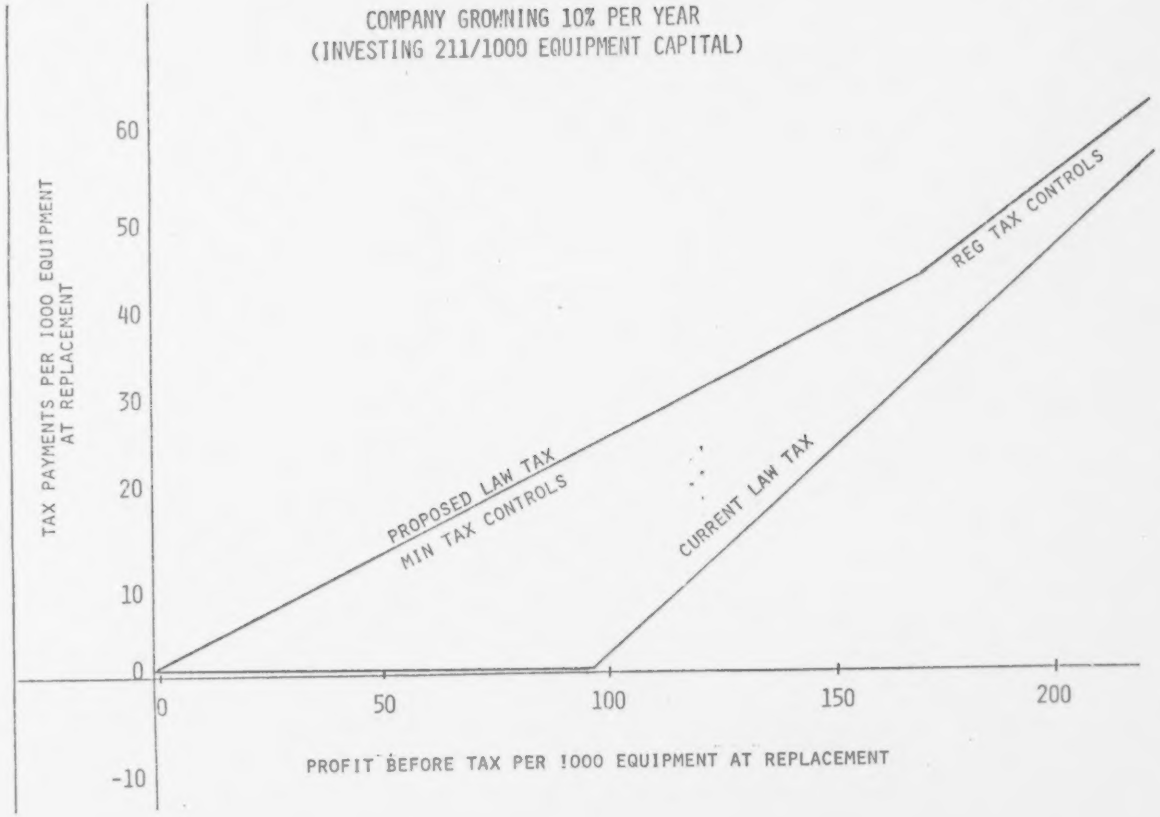
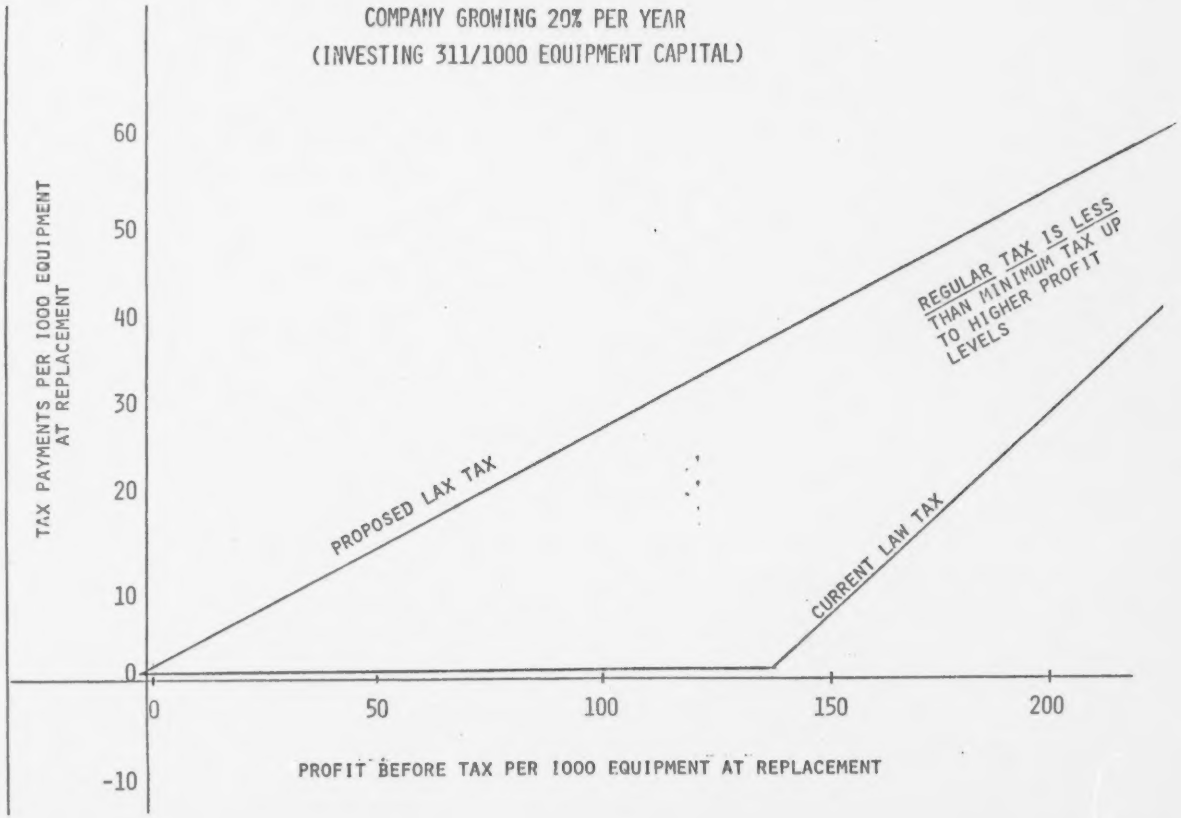


FIGURE D



COMPANY GROWNING 10% PER YEAR
(INVESTING 211/1000 EQUIPMENT CAPITAL)

FIGURE E



COMPANY GROWING 20% PER YEAR
(INVESTING 311/1000 EQUIPMENT CAPITAL)

FIGURE F

TAX BURDEN THRESHOLDS VS GROWTH

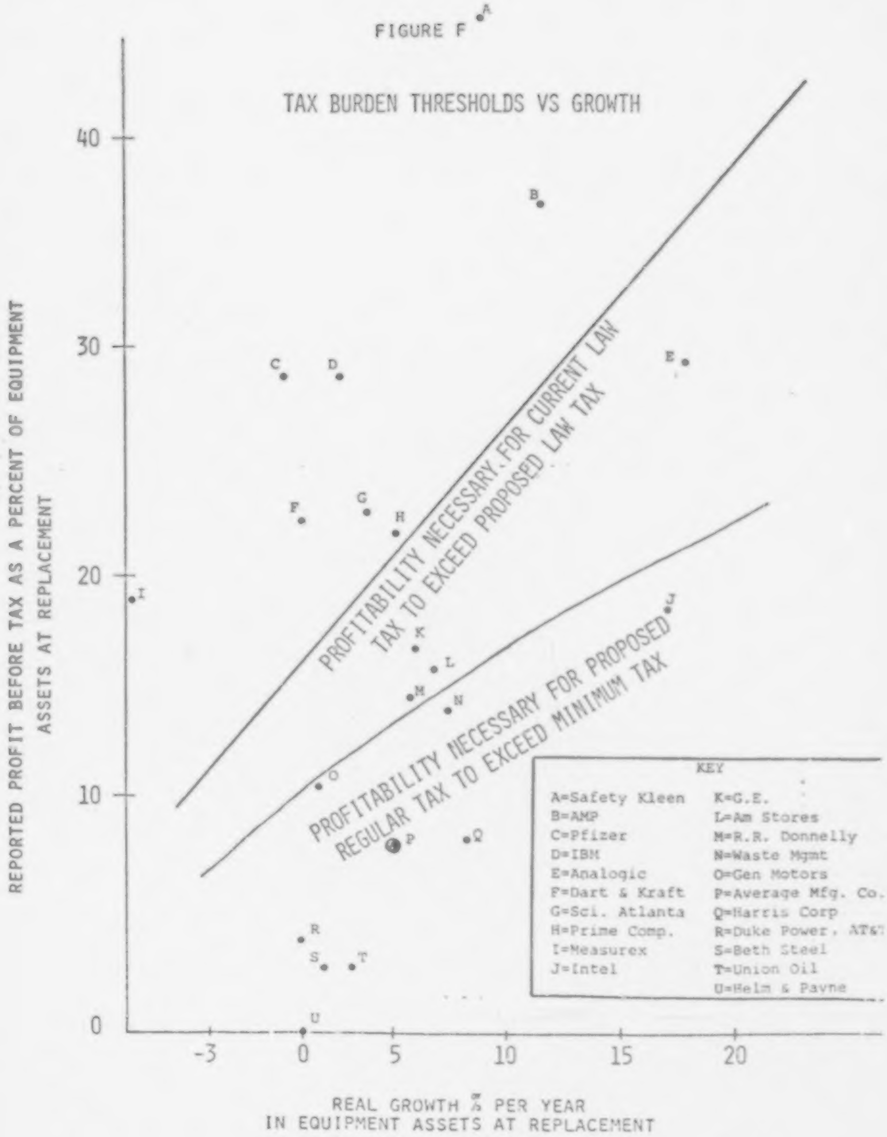


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TABLE I

SUMMARY OF CASE CALCULATIONS

	CURRENT YEAR (TAX) PAYMENTS				
			CURRENT LAW/ PROPOSED LAW		
PROFIT BEFORE TAX PLUS DEPRECIATION	50	100	150	200	300
Real growth in fixed assets					
-3% p.a. (investing < depr)	0/ 8.4	(2.8)/ (12.4)	(25.4)/ (27.1)		
0 (investing depr)	0/ 15.9	0/ (1.8)	(12.9)/ (21.3)	(35.4)/ (37.2)	
3 (growing w economy)		0/ (5.8)	(1.3)/ (18.3)	(23.8)/ (30.6)	
7 (good growth)			(0.5)/ (14.8)	(10.0)/ (27.3)	(55.2)/ (58.2)
10 (strong growth)		(0.5)/ (0.2)	(0.5)/ (12.7)	(0.5)/ (25.3)	(0.5)/ (50.2)
20 (hot growth)			(0.5)/ (7.2)	(0.5)/ (19.7)	(0.5)/ (4.24)

Only a few of the case calculations are attached. The rest are available on request.

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CASE 10/200

real growth = 10% p.a.
domestic fixed capital spending to achieve = 211.1/1000
domestic pre tax cash flow = 200 (good)

INCOME	CURRENT TAX LAW	11/85 W&M PROPOSAL
domestic cash flow b.t.	200.0	200.0
(less) tax depreciation	(158.3)	(148.6)
(less) FSC exemption	(3.6)	(3.1)
regular taxable	38.1	48.3
minimum tax preferences	3.0	52.1
TAX		
regular (tax) before credits	(17.5)	(17.4)
investment tax credits	16.9	0
net regular (tax)	(0.6)	(17.4)
minimum (tax)	(0.5)	(25.1)
REPORTED INCOME		
profit before tax	97.4	97.4
(tax) paid	(0.6)	(25.1)
(tax) timing entry	(27.3)	(9.8)
profit after tax	69.5	62.5
DISTRIBUTION		
remaining cash available for distribution	(11.7)	(36.2)

depreciation	
financial reporting amount	102.6
amount lost due to inflation	11.8

Other cases available upon request.

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TABLE II - COMPANY REFERENCES
(MILLIONS OF DOLLARS)

COMPANY OR DIVISION		IMPLIED REAL GROWTH[1]	PROFITABILITY[2]	(MM$) SALES	PROFIT BEFORE TAX	DEPRECIATION REPORTED	PROPERTY AT COST	FIXED CAPITAL SPENDING
Some Smaller Companies								
Prime Computer	84	5%	22%	642	70	40	227	59
Scientific Atlanta	84	4%	23%	437	27	11	85	15
Safety Kleen	84	8%	45%	163	29	7	47	12
ANA Logic	84	18%	30%	141	24.7	4.4	60.1	11.4
Measurex	84	(5%)	19%	123	8.9	5.6	33.5	3.6
Helmerich & (Brilling Div.)	84	0%	0%	97	1	26	165	28
Johnson Electronics	84	31%	50%	2.8	0.55	0.05	0.8	0.3

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[1] $$\text{IMPLIED REAL GROWTH} = \frac{\text{CAPITAL SPENDING - DEPRECIATION X INFLATION FACTOR}}{\text{BOOK FIXED ASSETS X REPLACEMENT FACTOR}}$$

[2] $$\text{PROFITABILITY} = \frac{\text{PROFIT BEFORE TAX}}{\text{BOOK FIXED ASSETS X REPLACEMENT FACTOR}}$$

CRUDE BOOK DEPRECIATION FACTOR = 1.08 AND FIXED ASSET REPLACEMENT FACTOR = 1.37

TABLE II - COMPANY REFERENCES
(MILLIONS OF DOLLARS)

COMPANY OR DIVISION		IMPLIED REAL GROWTH[1]	PROFIT-ABILITY[2]	(MM$) SALES	PROFIT BEFORE TAX	DEPRE-CIATION REPORTED	PROPERTY AT COST	FIXED CAPITAL SPENDING
Some Larger Companies								
Duke Power	83	1%	4%	2,420	449	325	8,568	536
Harris Corp.	84	7%	8%	1,996	95	101	821	183
Intel (Peak Year)	84	17%	19%	1,629	298	114	1,165	388
AMP Corp. (Post Growth Year)	79	10%	37%	1,013	228	34	445	96
Waste Management	84	6%	13%	773	154	64	879	139
R. R. Donnelly	84	5%	14%	1,814	231	90	1,240	175

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[1] IMPLIED REAL GROWTH = $\frac{\text{CAPITAL SPENDING - DEPRECIATION X INFLATION FACTOR}}{\text{BOOK FIXED ASSETS X REPLACEMENT FACTOR}}$

[2] PROFITABILITY = $\frac{\text{PROFIT BEFORE TAX}}{\text{BOOK FIXED ASSETS X REPLACEMENT FACTOR}}$

CRUDE BOOK DEPRECIATION FACTOR = 1.08 AND FIXED ASSET REPLACEMENT FACTOR = 1.37

TABLE II - COMPANY REFERENCES
(MILLIONS OF DOLLARS)

COMPANY OR DIVISION		IMPLIED REAL GROWTH[1]	PROFITABILITY[2]	(MM$) SALES	PROFIT BEFORE TAX	DEPRECIATION REPORTED	PROPERTY AT COST	FIXED CAPITAL SPENDING
Some Very Large Companies								
General Motors	84	1%	10%	83,890	5,504	4,900	41,051	6,047
IBM	84	2%	29%	45,937	11,623	4,474	29,423	5,473
AT&T	84	1%	4%	33,188	1,951	2,778	38,508	3,462
General Electric	84	6%	17%	27,947	3,356	1,100	14,769	2,488
American Stores	84	7%	16%	12,119	347	153	1,567	308
Dart and Kraft	83	1%	23%	9,714	817	179	2,548	219
Union Oil (Refining Operations)	84	3%	3%	8,677	92	106	1,956	198
Bethlehem Steel (Recent Better Year)	81	2%	3%	7,298	293	377	7,321	496
Pfizer	84	0%	29%	3,855	801	127	2,046	144

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[1] $$\text{IMPLIED REAL GROWTH} = \frac{\text{CAPITAL SPENDING} - \text{DEPRECIATION} \times \text{INFLATION FACTOR}}{\text{BOOK FIXED ASSETS} \times \text{REPLACEMENT FACTOR}}$$

[2] $$\text{PROFITABILITY} = \frac{\text{PROFIT BEFORE TAX}}{\text{BOOK FIXED ASSETS} \times \text{REPLACEMENT FACTOR}}$$

CRUDE BOOK DEPRECIATION FACTOR = 1.08 AND FIXED ASSET REPLACEMENT FACTOR = 1.37

GENERAL BASES

A. Company Cases Considered
   1. Various rates of profitability (expressed as the ratio of reported profit before tax to fixed assets at replacement)
   2. Various rates of real growth (expressed as the ratio of net investment to fixed assets at replacement).

B. Federal Tax Changes Considered (with state taxes ignored)
   1. Basic tax rates:
      - current law - 46%
      - proposed law - 36%
   2. Investment credit:
      - current law - 8% (option) of equipment placed in service
      - proposed law - none
   3. Depreciation:
      - current law - ACRS (5 yr schedule)
      - proposed law - 7 year DDB/SL
   4. Minimum tax:
      - current law - 15% on small base
      - proposed law - 25% on larger base including regular taxable income and accelerated depreciation preference

5. Foreign sales corporations:

   current law - exclusion of 15% of combined income

   proposed law - exclusion of 13% of combined income.

C. Domestic Operations

1. Domestic fixed investment at replacement = 1000
2. All investment in equipment with 9 year ADR life and 9 year real operating life
3. Reported income based on 9 year SL depreciation It is overstated by inflation loss plus some accelerated depreciation differential (difficult to define, so ignored here)
4. Inflation at 5% affects only the value of unindexed depreciation; other effects on financial assets are ignored
5. Margins defined after interest (if any) on debt. Working capital and debt finessed by this profit definition
6. Combined export income = 12% of domestic cash flow before tax.

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APPENDIX I

COMPANY DEPRECIATION TOTALS AS RATIOS TO AMOUNTS OF MID LIVED[1] EQUIPMENT PLACED IN SERVICE EACH YEAR

If companies were allowed to expense rather than depreciate capital expenditures, expense deductions each year would, of course, equal capital expenditures. This equality would hold at any rate of growth. Also, if a company's dollar capital expenditures were to remain constant for a period of years, any consistent schedule of total depreciation deductions would also exactly equal capital expenditures.

However, if a company's dollar capital expenditures are growing, its total annual depreciation from past and present capital spending is less than its current year capital expenditures. This shortfall is a function of the growth of the capital base throughout the depreciation period. For analysis purposes, it is useful to assume that company capital expenditures grow at constant rates and to calculate depreciation to expenditure ratios for different depreciation schedules at each growth rate. This enables a quick comparison of how depreciation reform affects companies whose capital expenditures are growing at different rates.

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[1] Calculations shown for Class 3 assets as defined for HR 3838.

Ratios of total allowed depreciation to capital placed in service at a number of growth rates are shown in the following table. Ratios to placements in service are slightly greater than ratios to capital expenditures because of growth during the lag between when expenditures are made and when capital is placed in service. The growth indicated is real growth excluding inflation, but calculations incorporate an additional five percent p.a. increase to nominal capital expenditures due to inflation.

The tabulation is shown for the ten years following a tax change to demonstrate the shortfalls that occur during phase-in to less rapid recovery schedules. The phase-in period is one year less than the changed recovery period. Average ratios over the first seven years of tax change were utilized in these company impact calculations because primary concern is with the near term. Note that phase-in shortfalls are not apparent from present value analyses of capital cost recovery values.

EQUIVALENT DEDUCTION PERCENT OF AMOUNTS PLACED IN SERVICE IN YEAR AS A FUNCTION OF REAL GROWTH IN CAPITAL SPENDING

										Fully Phased-In	Average Over 1st 7 Years
Year after tax change	1	2	3	4	5	6	7	8	9	10	
Current ACRS Law											
-3% growth										96	96
0%										90	90
3%										85	85
10%										75	75
20%										65	65
7 Yr 200 DB/SL (for regular tax)											
-3% growth	96	98	95	87	75	83	91	95	95	95	89.3
0%	90	92	89	82	72	79	85	88	88	88	84.1
3%	85	87	84	77	68	74	80	82	82	82	79.3
10%	75	77	74	69	62	66	70	71	71	71	70.4
20%	64	66	64	59	55	51	60	60	60	60	59.9
9 Yr SL (for minimum tax)											
-3% growth	87	76	67	57	48	58	68	78	87	92	65.9
0%	81	71	62	53	45	54	62	70	77	81	61.1
3%	76	66	57	49	42	50	57	63	69	72	56.7
10%	66	56	49	43	37	42	47	51	55	56	48.6
20%	55	46	40	35	31	35	38	40	42	42	40.0

Example: Deductions of a company having medium term real growth of 10% p.a. would decrease from 75% of placements in service under current ACRS law to 70.4% for regular tax under proposed law.

Capital cost recovery would be further decreased by repeal of the investment credit. Repeal of the investment credit is equivalent to reducing deductions by 8/0.36 = 22% of placements in service.

STATEMENT BY
THE EDISON ELECTRIC INSTITUTE
ON THE ALTERNATIVE MINIMUM TAX PROVISIONS OF H.R. 3838
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

FEBRUARY 3, 1986

The Edison Electric Institute (EEI) appreciates the opportunity to submit this statement regarding the alternative minimum tax provisions of H.R.3838.

EEI is the association of electric companies. Its members serve 96 percent of all customers served by the investor-owned segment of the industry. EEI members generate approximately 75 percent of all of the electricity in the country and provide electric service to 73 percent of the nation's consumers of electricity.

EEI believes that the foundation of the nation's tax system is predicated on the faith and perception that each taxpayer will pay a fair share of tax. We recognize that in recent years the average taxpayer's confidence in our country's tax system has been shaken due to perceived abuses. Thus, there is a need to ensure that any abuses are corrected and that each taxpayer pays a fair amount of tax. EEI urges that any minimum tax provisions maintain as a central goal the need for fairness and equity.

In this regard, EEI has reviewed the corporate alternative minimum tax (AMT) provisions contained in H.R. 3838, and has comments on four specific areas associated with these corporate AMT proposals. The four areas are:

1) the rate of minimum tax,
2) the expansion of tax preferences,
3) the investment tax credit offset, and
4) the minimum tax credit.

The Rate of Minimum Tax

In establishing the rate of a corporate AMT, we recommend consideration be given to the need to have a sufficient differential between the regular corporate income tax rate and the corporate AMT rate.

It is important to recognize that the differential under current law between the regular corporate tax rate of 46 percent and the minimum tax rate of 15 percent is substantial. However, H.R. 3838, as passed by the House, would significantly narrow this differential with a maximum regular corporate income tax rate of 36 percent and an AMT rate of 25 percent. The effect of narrowing the differential, while at the same time expanding tax preferences, could result in an ongoing AMT liability for certain taxpayers and industries. The AMT would, in effect, then displace the regular income tax.

Therefore, EEI recommends in any corporate AMT legislation that the corporate AMT rate not be greater than 50 percent of the regular corporate income tax rate.

Expansion of Tax Preferences

H.R. 3838 expands the list of tax preferences substantially, when compared to current law, principally at the expense of capital formation incentives. This expansion of preferences would discriminate against capital-intensive industries and would increase the cost of investment in plant and equipment. For taxpayers in such industries it is not realistic to enact such a broad expansion of the base for a corporate AMT, for such an expansion would further erode or even eliminate the incentive provided in the basic depreciation system and could result ultimately in an ongoing minimum tax liability for such capital-intensive taxpayers. Instead, any corporate AMT designation of depreciation as a preference should focus principally on depreciation with respect to tax-shelter arrangements that have generated the perceived corporate abuses.

The Investment Tax Credit Offset

Taxpayers with investment tax credit (ITC) carryovers and those that anticipate significant amounts of transition period ITCs may be unable to utilize such credits if the corporate AMT provisions of H.R. 3838 are enacted. Under current law, taxpayers can ultimately utilize ITC carryovers. However, H.R. 3838 would deny the use of ITC carryovers and transition ITCs as offsets against a corporate AMT except in very limited circumstances. Such a denial would have an adverse impact on those corporations that generally can least afford it. Capital intensive companies with large amounts of ITCs may always pay the AMT and would therefore never be allowed to use their ITCs.

The bill, as passed by the House, would penalize corporations that relied upon existing provisions of the Internal Revenue Code when investment decisions were made. More specifically, the denial of the ITC as an offset against the corporate AMT would make the ITC, in effect, a tax preference. That treatment would be a further unwarranted expansion of the list of tax preferences against capital-formation incentives.

The Minimum Tax Credit

It should be noted that electric utilities, as well as other businesses, often are subject to fluctuations in taxable income for reasons beyond the ordinary control of the taxpayer. Such fluctuations could cause a taxpayer to pay the AMT one year and the regular income tax the next. In the case of electric utilities, rate regulation could have such an impact.

H.R. 3838 provides for a minimum tax credit in the amount of the AMT to be permitted against the liability for the regular income tax in a future year. The credit could be carried forward for an unlimited period of years but could not be carried back. EEI supports this minimum tax credit provision and recommends that it be included in any final legislation.

Conclusion

EEI believes that ongoing tax-reform efforts that would: (1) repeal the investment tax credit, and (2) provide for a depreciation system with longer lives and slower recovery would have a direct adverse impact on capital-intensive industries such as the electric utility industry. To subsequently treat remaining capital-formation incentives as tax preferences items subject to the minimum tax would only negate the remaining benefit for industries which are capital intensive. Tax-reform efforts should not on the one hand provide incentives for capital formation which are taken away on the other hand by an onerous alternative minimum tax. EEI urges that any significant revenue enhancement be provided through the regular individual and corporate income tax system rather than through an AMT. The goal of any tax system, in EEI's view, is to ensure that each taxpayer pays a fair share of tax. If a corporate AMT is deemed to be necessary to ensure fairness of the income tax system, then we recommend that an AMT reflect the modifications described herein and that adequate transition rules are provided to ensure that the transition properties for depreciation and investment tax credit purposes are accorded current law tax preference treatment. The perceived abuses in the past by a few corporations should not result in an expanded minimum tax, which adversely affects basic industries and which discriminates against capital formation.

Thank you for the opportunity to express our opinion on this important legislation.

STATEMENT OF THE
INVESTMENT PARTNERSHIP ASSOCIATION

"The Minimum Tax Provisions of H.R. 3838"

Submitted to the
Senate Finance Committee
February 17, 1986

Christopher L. Davis, President
Investment Partnership Association
1050 Connecticut Avenue, N.W.
Washington, D.C. 20036-5303

The Investment Partnership Association ("IPA") is pleased to have the opportunity to offer its views on the alternative minimum tax provisions of the Tax Reform Act of 1985 (H.R. 3838).

I. What Are Investment Partnerships?

There are over four million limited partnership interests presently, including more than one million using funds from IRA and Keough retirement plans. There are limited partners in every state and congressional district in the country.

Investment partnerships are defined as limited partnerships sold through registered broker-dealers. The investment partnership industry (sometimes called the syndication industry) operates primarily in the real estate and oil and gas sectors, which account for 80 percent of total capital raised. Equipment leasing is the largest component of the balance of such investments. The principal vehicle for raising capital and investing in these sectors is the limited partnership, although real estate investment trusts ("REITs") and royalty trusts are also popular.

Newly compiled statistics demonstrate that investment partnerships are now a major source of new equity capital raised in the United States. In the last two years, 1984-1985, capital raised by limited partnerships totalled $37.7 billion, an amount surpassing the $33.9 billion raised through all forms of corporate stock issued during the same period.[*/] Clearly, any comprehensive tax reform legislation that is concerned with capital formation and cost of capital issues must take note of the key role played by investment partnerships.

The 1985 figures also demonstrate that the substantial growth in new partnership capital was concentrated in income oriented partnerships such as unleveraged real estate acquisitions, mortgage loans for real estate, Finite Life Real Estate Investment Trusts ("FREITs"), oil and gas Master Limited Partnership ("MLPs"), and income oriented equipment leasing partnerships. By contrast, equity invested in tax shelter oriented transactions, leveraged real estate, oil and gas drilling, and tax shelter oriented equipment leasing, declined slightly.

II. The Minimum Tax Provisions of H.R. 3838

While the minimum tax provisions of H.R. 3838 retain the basic structure of the current minimum tax, they substantially broaden the applicability in several important respects. First, the basic rate is increased from twenty to twenty-five percent. Second, the deductions permitted against the minimum tax base are changed as is the basic exemption amount. Finally, a number of new tax preferences are added that

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[*/] Robert A. Stanger & Co. News Release, January 15, 1986.

substantially broaden the minimum tax base. The most noteworthy is a new "passive loss" preference which requires all losses from passive investment in excess of the taxpayer's cash basis (with a $50,000 cap for investments defined as tax shelters by the Deficit Reduction Act of 1984) to be added back to the taxpayer's minimum tax base. In essence, certain business losses attributable to "passive investments" would not be deductible for purposes of the minimum tax.

The balance of this statement will be devoted to examining the economic impact of these provisions.

III. Analysis of Minimum Tax Provisions of H.R. 3838

The individual minimum tax was first approved as part of the Tax Reform Act of 1969.*/ The accompanying Ways and Means Committee Report summarized the reasons for the new section:

> Your committee believes that no one should be permitted to avoid his fair share of the tax burden--to shift his tax load to the backs of other taxpayers . . . The objective of this provision . . . is to insure that the minority of high income individuals who pay little or no tax under present law will generally no longer be able to do this.**/

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*/ P.L. 91-172.

**/ House Report (Ways and Means Committee) No. 91-413, reprinted in U.S. Congressional and Administrative News, 91st Congress, 1st Session, p. 1725.

The present minimum tax was enacted in 1982 as part of the Tax Equity and Fiscal Responsibility Act. As the Senate Finance Committee noted:

> The committee has amended the minimum tax provisions applying to individuals with one overriding objective: no taxpayer with substantial economic income should be able to avoid all tax liability by using exclusions, deductions, and credits . . . The ability of high income individuals to pay little or no tax undermines respect for the entire tax system. . .[*]

The major interest of the Congress in imposing a minimum tax for individuals was to ensure that everyone paid a fair share of their income in taxes to support the federal government. The focus was clearly on high income individuals who had utilized a combination of tax preferences to virtually avoid tax liability. The Congress was concerned that this appearance of unfairness undermined respect for the system in the eyes of all taxpayers. The minimum tax historically then has sought to address this limited situation.

While the report accompanying H.R. 3838 offers a similar rationale for its minimum tax provisions,[**] it is clear on closer examination that the bill's authors had other objectives.

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[*] Senate Report (Finance Committee) No. 97-494, July 12, 1982, p. 108.

[**] The language of the House Report is almost identical to that of the TEFRA report:

(footnote continued)

The House bill goes far beyond the "fairness" objective and substitutes a second tax system designed to raise enough money to ensure a revenue neutral tax reform bill. For calendar year 1982, the minimum tax raised approximately $1.5 billion from individuals. By contrast, H.R. 3838 expects to generate over $19 billion through 1990. It is not possible to raise such a large amount of money just from very wealthy individuals who currently pay little or no tax. This very broad provision will directly affect a larger number of middle income taxpayers.

The House bill raises the minimum tax rate from twenty to twenty-five percent. At the same time the regular tax top marginal rate is lowered to thirty-eight percent. Now, the minimum tax is forty percent of the top regular rate. The House bill would put it at nearly sixty-six percent of the top regular tax rate. The spread is so narrow that two

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(footnote continued)

> The Committee believes that the minimum tax should serve one overriding objective; to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits . . . The ability of high income taxpayers to pay little or no tax undermines respect for the entire tax system. p. 306.

sets of calculations will be necessary for virtually all investment projects that run over a period of years, clearly complicating many financial transactions.

Under H.R. 3838, practically all deductions, exemptions, credits and income sources would be examined first for treatment under the regular tax and then for classification for purposes of the minimum tax. If individual incentives are not effective or desirable, they should be dealt with directly, rather than indirectly through the back door by a minimum tax. To the extent that such reliance must be placed on a minimum tax, one can conclude that the tax reform effort has not succeeded.

Imposing a modified flat tax through H.R. 3838's strengthened minimum tax is really the worst of both worlds. Since two sets of calculations are required for most transactions, the code becomes more, not less, complex. Additionally, because the rate is set so high (twenty-five percent), greater investment and the growth of our capital stock may be slowed significantly.

Because the minimum tax provisions of H.R. 3838 are designed to raise large amounts of additional revenue, it does much more than its primary job of ensuring that all taxpayers pay a fair share of their income in taxes. Witnesses in hearing before the Senate Finance Committee have already indicated that wealthy taxpayers would probably shift their investments into tax exempt bonds, for example.[*/] Significantly, wealthy individuals with large amounts of investment income could avoid the passive loss provisions, thus defeating the primary purpose of a minimum tax, e.g., to insure that everyone will pay some tax.[**/]

The House bill is in pursuit of those individuals who defer income and pay little tax.[***/] Their product, however, represents overkill in that many less than wealthy individuals will be subject to the new tax because of the small difference between regular marginal rates and the minimum tax rate. The Committee aimed for the very wealthy and hit the middle and upper middle class. This will likely increase, not decrease, the level of public cynicism regarding the tax system.

IV. The Passive Loss Preference

One new preference added by H.R. 3838 is for "passive losses." An investor would not be able to deduct losses that exceed the taxpayer's cash basis. A $50,000 limitation is placed on "tax shelters" as defined by the Deficit Reduction

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[*/] Senate Finance Hearing, February 3, 1986; Answer by John W. Hamm in response to question from Senator John Danforth.

[**/] See discussion p. 9

[***/] For calendar year 1982, of 207,000 individuals with "expanded income" in excess of $200,000, 299 (0.1%) paid no federal income taxes. See IRS Statistics of Income, Individual Returns, 1982, p. 119.

Act of 1984. The proposed preference has many flaws and should be abandoned for a number of reasons.

First, under the House bill, the ability to deduct a loss is based on the form of ownership, rather than on the specific business expense. Thus, operating expenses or interest expense of a limited partnership owning property would not be deductible beyond a certain amount while the same expenses for similar property owned by a corporation or a sole proprietorship would continue to be fully deductible. If the Congress wishes to limit particular deductions or credits, it should do so directly and for everyone. It makes little sense to discriminate against partnerships as an ownership form.

Second, the preference is so broad as to deny deductibility of legitimate economic losses. Out-of-pocket costs for operations and interest, for example, could be disallowed. Even a portion of a shrunken cost recovery schedule is subject to the preference. While some credits cannot be measured precisely in economic terms, the bulk of investor deductions can be clearly justified on economic grounds.

Third, by limiting deductible losses to cash invested, the provision is biased against investments with an element of risk and in favor of "safe" investments. Ventures with longer start-up times or those with greater risk that generate losses in the first few years of operation (oil and gas drilling, certain research and development projects, certain multi-family housing projects) will have greater difficulty attracting a portion of a smaller pool of capital. The ability of partnerships to finance new technological ventures would thus be severely impacted.

Fourth, the preference discriminates against salaried middle income investors and in favor of wealthy individuals who have large amounts of investment income. This occurs because wealthy individuals are permitted a full deduction against investment income. It is contrary to the goal of fairness to limit the losses a middle class professional can offset against wages and salary and at the same time to permit a wealthy individual to fully deduct losses against income from stocks and bonds.

Fifth, the Committee's analogy of a limited partner to a shareholders in a C corporation is incomplete. It is true that, unlike a stockholder who must dispose of his stock for his loss to be recognized, a limited partner is able to take an immediate deduction for a business loss. However, it is also true that income attributable to a limited partner (including that in excess of his cash flow and before disposition of the asset) is taxable in that same year. By contrast, stock appreciation is not recognized until disposition. To be consistent, H.R. 3838 should provide for the deferral of the income of a limited partner in a partnership.

Sixth, the IRS and the judiciary will be faced with another set of threshold questions and will be called upon to define such terms as "passive investors," "material participation" and "substantial personal services" in an attempt to determine which partners are subject to the passive loss preference and which are not. Clearly, this will slow and inhibit the IRS in utilizing its new powers, including its ability to conduct partnership-wide audits. The courts will be asked to determine the status of investors in literally hundreds of thousands of separate transactions.

Seventh, the preference would apply to investments already made based on current tax law. This amounts to changing the rules in the middle of the game and will play havoc with investors seeking to determine their potential liability. As a matter of basic fairness, any new tax law should apply only to new investments.

Finally, the provision will require the IRS to develop a new set of rules governing "cash basis." This represents a third set of books to complement the current "basis" and "at risk" calculations. This drains time and resources that could better be devoted to cracking down on abusive tax shelters.

V. Conclusion

The minimum tax provisions of H.R. 3838 are fundamentally flawed and should be substantially rewritten by the Senate

Finance Committee. Any minimum tax change should accomplish the long-stated goal of ensuring that the very wealthy pay some tax. Certainly, any change should not move us away from the tax reform goals of fairness, simplicity and economic growth. Neither should it be a retroactive tax nor a tax levied at a rate that undermines the incentive effect of basic tax provisions for regular tax purposes.

JACKSON HOLE LAND TRUST

February 7, 1986

Senator Robert Packwood, Chairman
Senate Finance Committee
SD-219
Dirksen Senate Office Building
Washington, D.C. 20510
Attention: Betty Scott-Boom

Dear Senator Packwood:

Please enter the following statement in the record of the hearing which the Senate Finance Committee held on February 3, 1986 regarding the Alternative Minimum Tax.

The Jackson Hole Land Trust is a private nonprofit land conservation organization which owns property and conservation easements protecting 3,224 acres of scenic and wildlife land buffering Grand Teton National Park. All land and easements have been acquired by donation since December 1981, and we expect several more such gifts in 1986 and beyond.

We are very concerned about the provision in the House version of the Tax Reform bill which would treat the appreciated portion of a charitable donation as a tax preference item for taxpayers subject to the Alternative Minimum Tax. We believe this provision would substantially decrease the number of charitable gifts and bargain sales of land and easements for conservation purposes, because the value of such gifts for AMT taxpayers would be limited to cost basis, which in many cases is far lower than fair market value. We urge the Finance Committee to delete this provision from the tax reform bill.

Although I don't have sufficient information about the finances of our land and easement donors to determine the exact impact this provision would have here, I do know that many of these donors are in the top tax bracket and almost certainly have other tax preference items which subject them to the Alternative

Photo: Phil Hocker

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Minimum Tax. I believe this is likely true of five of the donors from whom we received donations of land or easements in the last five months, donations which protected a total of 1,400 acres of outstanding conservation land. Whether these donors would have made gifts had the value been limited to cost basis I do not know. It seems reasonable to assume that some would not, and that many of those acres would not have been protected.

We urge the Committee to recognize the great disservice this provision would do to private efforts such as ours to conserve some of our nation's most outstanding land resources.

Although land conservation organizations are in a unique position among charities in our fundamental dependence on donations to carry out our purposes, this provision would also have a serious effect on charitable giving generally. It is no surprise that people who are in a position to most generously support charitable organizations often choose to do so through gifts of appreciated securities and other property. And these same people are most likely to be AMT taxpayers. It does seem inconsistent, at a time when the nation is depending increasingly on the private sector to support charitable endeavors, that Congress would enact a measure which will thwart private giving.

Again, we urge you not to include this provision in the Senate tax reform proposal.

Thank you for the opportunity to submit our concerns.

Sincerely,

Jean Hocker

Jean Hocker
Executive Director

JH/sar

Montana Land Reliance

Office: 107 W. Lawrence, upstairs Helena, Montana 59624 P. O. Box 355 (406) 443-7027

February 13, 1986

Ms. Betty Scott-Boom
Committee on Finance SD-219
Dirkson Senate Office Building
Washington, D.C. 20510

Dear Ms. Scott-Boom:

We wish to express our concern with the charitable deduction provision of the Alternative Minimum Tax proposals.

During the last eight years the Montana Land Reliance has protected with conservation easements eleven ranches totaling 38,000 acres. These properties contain magnificent scenic open space, habitat for several thousand head of big game animals, and more than 50 miles of some of the finest remaining trout habitat in the lower 48 states, including the Madison, Yellowstone, Big Hole, Missouri and Blackfoot Rivers. The chief threat to these resources is primary and second home development. Nine of these eleven landowners would not have donated an easement unless they could have utilized the charitable donation. If these nine landowners had not donated, 27,000 of these 38,000 acres would not have been conserved. The majority of the nine landowners who claimed the deduction were in an income bracket where they undoubtedly claimed other deductions as well.

Montana is a national treasure in terms of recreational resources and will become increasingly important to the nation as the opportunity to experience unspoiled outdoor experiences declines on the East and West coasts as they continue to undergo rapid development. Here in Montana, tourism-recreation is our second largest industry and will become even more important to the state's economy as timber and mining resources are depleted.

The key to maintaining the attractiveness of our tourism-recreation resources is the conservation of our high quality scenic beauty and fish and wildlife habitat. We must do everything possible to encourage good stewardship of both our public and our private land and water resources.

The health of Montana's superb elk and deer herds depends upon the availability of adequate winter range. Much of the best winter range exists on private lands in the foothills of our river valleys. Virtually all our world-renowned trout waters flow through private lands in the valley floors.

Those private landowners who are good stewards of their lands provide scenic open space and fish and wildlife habitat that directly or indirectly benefits everyone.

One of the best ways to permanently protect the resource values provided by relatively undeveloped, well-managed private lands is the conservation easement.

A conservation easement is the donation of development rights on a property. This also normally involves legal restrictions that ensure the land will always be managed in an ecologically sound manner. The chief purpose of the easement is to protect the resource base. When a rancher whose land contains prime winter range adjacent to public land sells out to a subdivider and the herd declines, that impacts everyone who hunts on that public land. Similarly, when an important spawning tributary to the Yellowstone River is ruined by overgrazing or by dewatering during spawning season, that hurts all of us who fish the main river.

Conservation easements are an excellent tool because not only can they permanently protect soil and water quality, fish and wildlife habitat and scenic vistas forever, they also keep the land in agricultural production, keep the land on the tax rolls and keep the land in private ownership and management. Oil and gas extraction can occur carefully. This is an era of tight state and federal dollars for conservation. It is far cheaper to acquire and monitor a conservation easement than to have the state or federal government buy the land outright and then have to manage it forever.

Today there are 535 local and regional private, nonprofit land trusts operating in 45 states, up from just 53 in 1950. They have protected more than 1,700,000 acres, 450,000 acres by conservation easement. This does not include the accomplishments of national conservation organizations, such as The Nature Conservancy.

State governments increasingly recognize the cost-effectiveness and the balanced approach offered by this tool. Wyoming's Department of Fish and Game has a very successful conservation easement program. The Montana Department of Fish, Wildlife and Parks recently established a conservation easement program that will focus on protection of elk winter range.

Pat Noonan, chair of the President's National Commission on Outdoor Recreation's task force on new ideas and approaches for meeting recreational needs recently stated that "conservation easements are the most important tool we have today in the conservation movement." We agree.

As we understand it, under the AMT a gift to a land trust is still a gift, but it is not worth as much. A dollar of contributed property value that is now worth 50 cents on the dollar for someone on the maximum tax bracket, might be worth as little as 20 cents on the dollar under AMT calculations.

As things stand under the present tax law, potential easement donors very frequently decide not to donate a conservation easement because the tax savings is far less than could be realized by the sale of the property. We urge the committee to refrain from making the most important conservation tool we have less attractive than it is at present.

Sincerely,

William H. Dunham
Executive Director

wd/ld

cc: Senator Max Baucus
David Brockway
Kingsbury Browne
Senator Robert Dole
Ben Emory
Senator Malcolm Wallop

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RHONDA M. WEXLER
CHARLES A. YUEN

*ADMITTED IN NEW YORK ONLY

February 14, 1986

The Honorable Bob Packwood
Chairman
United States Senate Finance Committee
Washington, D.C.

Dear Senator Packwood:

Please consider this a statement in connection with the Senate Finance Committee Hearings on the Alternative Minimum Tax proposals contained in the House of Representatives passed Tax Reform Bill (HR 3838).

I am a lawyer in Hartford, Connecticut, practicing in the area of tax law and the legal problems of exempt organizations. As both legal counsel, and a volunteer, I have been involved with numerous local charities, including:

Wadsworth Atheneum (art museum)

Kingswood-Oxford School (independent secondary school)

Old Sturbridge Village (historic museum)

Connecticut Educational Telecommunications Corporation
(public television and radio station)

United Way of the Capital Area

YMCA of Metropolitan Hartford

St. Francis, Hartford, and Mount Sinai Hospitals

Amherst College

Yale Law School

I am writing this letter as a private citizen, and not in any official capacity with any of these institutions.

Each of these private tax-exempt institutions has been supported through the years by the generosity of countless individual, corporate, and foundation donors. Through such generosity, they have been able to balance their operating budgets, establish and/or increase their endowments, and obtain outstanding collections of works of art, books, and manuscripts. The charitable contribution deduction has been a vital factor in inducing and encouraging this munificence.

Much of the most significant support has come by way of gifts of appreciated property, particularly in the case of capital campaigns for buildings and endowment, and in the case of important additions to their collections.

In major capital campaigns, it is estimated that over 80% of the support is received in the form of appreciated securities.

Few institutions have the acquisition funds to purchase outstanding art objects, books, or manuscripts, in today's highly inflated market, and must obtain these objects, if at all, through donations.

Unfortunately, the Tax Reform Bill recently passed by the United States House of Representatives, and soon to be considered by your Committee, contains a powerful disincentive to continued charitable gifts of appreciated property--the making of the appreciation factor in many cases a so-called "preference item"--subject to a 25% minimum tax. In my opinion this provision is entirely counterproductive, and would have a devastating effect on the ability of these charities to obtain such gifts.

In approving such a provision, the House Ways and Means Committee must have believed that gifts of appreciated property were a "tax dodge," an unwarranted tax benefit enjoyed only the well to-do.

May I make the following points:

(1) Congress in 1984 established rigorous substantiation provisions, and significant overvaluation penalties, concerning such gifts, in an effort to prevent abuses. These provisions should be given the opportunity to take effect before further disincentives are established in this area;

(2) No individual may eliminate his or her tax liability by way of such gifts--the Internal Revenue Code

restricts deductibility of such contributions to 30% of the taxpayer's adjusted gross income.

(3) It is true that most gifts of appreciated property will be made by the Well to-do. However, such gifts invariably are to *public charities*, which serve the public at large.

(4) With the maximum tax on ordinary income now at 50%, and the top capital gain rate at 20%, a taxpayer may *not profit* from a donation of properly-valued appreciated property to charity-*i.e.*, a taxpayer will always be *worse off* from a contribution than a sale.

For example, assume that a 50% tax bracket taxpayer has a tax basis of $10,000 for a painting valued at $110,000. If he sells the painting for $110,000, and pays a commission of $10,000, he will net $100,000, with $90,000 of long-term capital gain. On that, he will pay a capital gains tax of $18,000, leaving him with $82,000. If he gives a $110,000 painting to a museum, his maximum tax saving will be $55,000. The net in favor of the sale is $27,000.

Thus, it is impossible for someone to "make money" through a charitable gift of appreciated property. That is as it should be, for the basic motive in giving should be a desire to benefit the institution, not to better oneself financially. Unfortunately, the above-mentioned provision would provide a still further significant disincentive, which, in many cases, may tip the scale against any gift at all.

(5) The current deduction allowed for gifts of appreciated capital gain property is efficient. It is estimated that such provision allows the raising of $1.20 in charitable gifts for each $1.00 of foregone revenue.

(6) The effect of the proposed provision, in any event, on the Alternative Minimum Tax, would be *minimal*, since an estimated 93% of taxpayers would be still subject to the minimum tax even if gifts of capital gain property are not included. However, the effect on charitable giving would be *maximal*. Econometric studies estimate that this change would reduce charitable giving by some $3 billion in 1986 alone.

> This loss would not translate into a gain for the United States Treasury. Its effect would be to encourage taxpayers to continue to hold appreciated property rather than contributing.

It is my hope and desire that you and your Committee, after considering the above points, and similar arguments made by many other concerned citizens, will take action to eliminate the "appreciation factor" as a "preference item" for Alternative Minimum Tax purposes.

Respectfully submitted,

James B. Lyon

James B. Lyon

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STATEMENT OF THE NATIONAL MULTI HOUSING COUNCIL
BEFORE THE COMMITTEE ON FINANCE,
UNITED STATES SENATE,
FOR THE HEARING RECORD OF FEBRUARY 3, 1986
CONCERNING THE PROPOSED ALTERNATIVE MINIMUM TAX

STATEMENT OF THE NATIONAL MULTI HOUSING COUNCIL
BEFORE THE COMMITTEE ON FINANCE,
UNITED STATES SENATE,
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CONCERNING THE PROPOSED ALTERNATIVE MINIMUM TAX

The National Multi Housing Council is very concerned that the proposed alternative minimum tax contained in H.R. 3838 will both severely curtail the supply of new equity capital available for investment in rental housing and, because of its retroactive impact, also force the withdrawal of substantial amounts of existing equity, threatening our vital housing stock. The National Multi Housing Council is a trade association of the major builders and developers of rental housing nationwide. Its over 6,000 members are engaged in all aspects of the ownership and operation of rental housing. Together they are responsible for hundreds of thousands of dwelling units.

Federal budgetary constraints have now forced the elimination of most federal housing subsidy programs. Tax incentives, including tax-exempt financing for targeted low income housing, are virtually the only means by which private investment capital can be attracted to supply housing for those Americans who rent. Rental housing, in general, cannot produce the positive cash flow returns in the early years of operation that are available from commercial real estate, such as office buildings and shopping centers. One major developer of both residential and commercial properties has computed average pre-tax rates of return of 13.5 % for its commercial properties and 8.5 % for its residential properties, a 60 percent differential. Clearly, rental housing cannot compete with commercial real estate for investment capital on a pre-tax basis.

Rental housing experiences longer initial rent-up periods because, unlike commercial buildings, apartments cannot be pre-leased. Moreover, increased after tax operating costs can rarely be passed through to tenants, even where there are no state law restrictions on rent increases, because most tenants simply cannot afford to pay more. Renters in general are lower income families: the median income of the renter population ($13,100 in 1984) is only approximately one-half the median income of homeowners, and by 1983, the proportion of renter households paying more than 35% of their income for rent had risen to 32 percent. These poorest families will suffer severe hardship and outright displacement if housing supplies diminish and rents increase dramatically under "tax reform."

The Proposed Alternative Minimum Tax Will Create a Parallel Tax System for Middle and Upper Income Taxpayers

H.R. 3838 would raise the alternative minimum tax rate for both individuals and corporations to 25% while lowering maximum regular income tax rates to 38% for individuals and 36% for corporations. Because the individual minimum tax rate would be 66% of the maximum federal income tax rate, as compared with 40% under current law, and because many significant personal deductions are disallowed for alternative minimum tax purposes, this proposed new minimum tax would affect many taxpayers with little or no geniune tax preference income and with substantial regular income tax liabilities. State and local income, property and sales taxes, medical expenses to the extent of the second 5% of a taxpayer's adjusted gross income, excluded long-term capital gain income adjusted to result in a 22% tax rate, interest on tax-exempt bonds used to finance rental housing and other so-called "nonessential" functions, personal non-home-mortgage interest in excess of net investment income, accelerated depreciation on any business property, and any other miscellaneous business and investment expenses will effectively be treated as preference items and, to the extent that they total more than $40,000 for a married couple, subject to a 25% tax rate. Thus, this "minimum" tax will no longer be a fallback vehicle ensuring that all taxpayers pay some fair share of tax, but rather will become the basic tax regime for many middle income Americans compounding the complexity and intrusiveness of our tax system. The National Multi Housing Council believes that it is a grave policy error to transform the minimum tax in this fashion into a primary revenue source.

For example in 1986, a two-earner married couple with $60,000 of salary income, a $20,000 long-term capital gain, $14,000 of state and local income and property taxes and $10,000 of personal non-mortgage interest expense would be subject to alternative minimum tax liability under H.R. 3838 follows:

Regular Tax Computation

$70,000 (AGI - Salary + 50% Capital Gain)
-10,000 (Interest)
-14,000 (State Tax)
- 3,000 (Exemptions adjusted for itemized deduction floor)
$43,000 (Taxable Income)

Tax=$22,500 x 15% + $20,500 x 25% = $8,500

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Minimum Tax Computation

$70,000 (AGI)
+10,000 (Excluded Capital Gain)
-40,000 (Exemption)
$40,000 (Minimum Taxable Income)

Tax=$30,000 x 25% + $20,000 x 22% = $9,400

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Clearly, most Americans (with the possible exception of the very wealthy) with significant capital for private investment will be threatened with this minimum tax and will refrain from taking advantage of any additional federal income tax incentives -- including those incentives which the Ways and Means Committee was careful to preserve for investments in housing for low and moderate income families -- out of concern over the potential minimum tax impact in later years. Accordingly, the chilling effect of this proposed alternative minimum tax on investments in housing will far exceed the broad sweep of the tax itself.

The New Tax Preference For Net Passive Investment Losses Results in an Unprecedented Disallowance of Real Economic Losses

H.R. 3838 creates a new item of tax preference for so-called "net passive investment losses" which include the aggregate net losses from all business and investment activities that are not actively managed by the taxpayer in excess of the lesser of $50,000 (for activities such as rental housing which generate initial losses) or the taxpayer's aggregate cash basis in passive investments. For this purpose, a taxpayer's cash basis is narrowly defined so that, for example, no partnership liabilities are included in the cash basis of an inactive partner. Thus, although H.R. 3838 independently limits the deduction of losses from investments in rental housing to the extent that the investor is not "at risk" for those amounts, even liabilities which pass muster under this expanded at-risk rule will not be included in cash basis for purposes of the proposed minimum tax. This inequity is compounded for investors in loss-generating activities such as rental housing who may not be allowed to deduct the (one-for-one) loss of their cash investments because of the $50,000 annual limit.

All expense items which are not otherwise treated as tax preferences under the alternative minimum tax are included in the computation of net losses subject to a tax benefit rule which presumably will exclude items which did not reduce adjusted gross income under the regular income tax computation.[1] However, because the minimum tax already deals

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[1] For example, interest expenses incurred in limited business investments are not deductible for federal income tax if, together with other non-mortgage personal interest, they exceed the taxpayer's net investment income plus $10,000 ($20,000 on a joint return). Therefore, if interest from a limited business investment in excess of the allowable income tax deduction were included in the net loss computation for

[Footnote Continued on Next Page]

directly with items of income tax exclusion and deferral, those expenses included in the net loss computation are, by definition, items which Congress deliberately did not categorize as tax preferences.

In evaluating the gain or loss from the typical rental housing project, all operating expenses exclusive of debt service (i.e., mortgage interest) are subtracted from the aggregate gross income from the property to obtain what is termed "free and clear cash flow". If the resulting amount is negative, this shortfall would be treated as a net loss tax preference item even though it consists of only the direct operating expenses of the rental housing business. Next, allowable cost recovery is subtracted from this free and clear cash flow. For purposes of the minimum tax net loss computation, depreciation is limited to 40-year straight line cost recovery, since any excess depreciation deductions allowed for income tax purposes are treated as a separate preference item. (Although 40-year straight line cost recovery allegedly represents "economic" depreciation for rental housing, the

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alternative minimum tax purposes, such interest would effectively be taxed twice, in that it would be both included in adjusted gross income and added back again as a tax preference.

National Multi Housing Council believes that this amount is totally inadequate to compensate owners of these assets, compounding the harshness of this minimum tax.)

Finally, debt service is accounted for. For purposes of the alternative minimum tax, the amount of mortgage interest included in the net loss computation is presumably that portion of total debt service which was deductible for federal income tax purposes under both the at risk rule and the investment interest limitation; therefore, this amount cannot exceed $10,000 per taxpayer plus net investment income.[2] Moreover, Congress has fashioned careful rules which now prevent taxpayers from claiming interest deductions before the period to which the expense relates and before the lender is required to recognize the corresponding interest income. Accordingly, any interest which is included in the net loss preference item is a current business expense which has been recognized as income by the lender and for which the taxpayer is considered bona fide under the at risk rule.

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[2] H.R. 3838 specifically exempts investors in targeted low income housing from the interest limitation. Inclusion of these interest amounts in the net loss preference computation, however, completely nullifies the incentive effect of this exemption for all but the very wealthiest investors.

The National Multi Housing Council believes that it is contrary to any legitimate use of a minimum tax to prevent taxpayers engaged in active businesses from deducting their actual operating expenses. Certainly, there has been no suggestion that such taxpayers should not pay current income tax on the positive cash flows from these investments simply because the investment has not been disposed of and a final gain or loss computation cannot be made. The federal income tax reforms of 1982 and 1984 now prevent taxpayers from obtaining deductions for prepaid or deferred expenses and for premature accruals where the corresponding income is not recognized. The treatment of the remaining legitimate expenses of a rental housing business as tax preferences is unwarranted.

In addition, the National Multi Housing Council believes that it violates the fundamental principles of our income tax system to prevent taxpayers from deducting business expenses currently, whether for regular or alternative minimum tax purposes. By ignoring amounts which have been spent in conduct of an active business, the proposed minimum tax overstates a taxpayer's economic income defined as the increase in his net worth. This will, in effect, transform our income tax into an excise tax on selective businesses, such as rental housing, which operate in partnership form, thereby disadvantaging them vis-a-vis alternative investments.

The Net Passive Loss Preference Item is Unfairly Retroactive.

Taxpayers who entered into investments in rental housing prior to the passage of H.R. 3838 will find that post-1985 losses from these investments will be included in the new minimum tax preference computation although their investments were made in reliance on a very different tax code and in the reasonable expectation that the costs of operating this business would be fully deductible. Because rental housing generally requires a period of years before it is able to generate positive cash flow, many investors who justifiably relied on the tax laws in selecting their investments will find that they overpaid for their property. Previously deductible costs will now be subject to a 25% rate of tax, unfairly decimating the planned return from these investments. Moreover, taxpayers who are shifted between the alternative minimum tax and the regular income tax will permanently sacrifice substantial income tax benefits -- first because of the loss in time value of certain deferral preference items during minimum tax years, and second because the proposed alternative minimum tax credit for these deferral items against subsequent income tax liability reduces them by the full amount of the annual minimum tax exemption ($40,000 on a joint return).

This retroactivity will penalize not only good faith investors in rental housing, but also those housing projects which still need additional funds to cover annual operating deficits. Even projects which would normally borrow to meet such deficits may find that lenders are unwilling to advance additional amounts because of this tax reform threat. Accordingly, many existing projects may fail. In addition, many investors may seek to terminate these investments causing a severe disinvestment in housing and a potential loss of housing stock as it deteriorates and is not maintained or renovated due to a lack of funds. Thus, the proposed minimum tax creates a true counter incentive, causing taxpayers to terminate their investments in favor of a non-tax-favored use. In this manner, the Congress will be discouraging precisely those investments which it intented to encourage by creating the tax incentives in the first instance.

The Alternative Minimum Tax Subverts the Clear Congressional Intent to Encourage Investments in Rental Housing.

Congress has traditionally provided tax incentives for the production of rental housing in the form of favorable depreciation and recapture rules in the recognition that, without some tax benefits, rental housing cannot generate a competitive investment return. H.R. 3838 carefully preserves these direct tax benefits for investments in targeted housing. Projects which meet the new targeting requirements will qualify for tax-exempt financing (subject to state volume limitations), for accelerated depreciation and for exemption from the limitation on interest deductions. However, each of these incentives: the interest on the bonds, the accelerated component of the depreciation in excess of 40-year straight line recovery, any capital gain from disposition of the property and the unlimited interest expense deduction (to the extent of the overall net loss) are treated as preference items under the alternative minimum tax. Given the scope of this tax, the National Multi Housing Council doubts that there will be many investors who can confidently avail themselves of these incentives without incurring or fearing alternative minimum tax liabiliy.

Moreover, even non-targeted rental housing which is restricted to 30-year straight line cost recovery under H.R. 3838 creates minimum tax preference income to the extent of the excess over 40-year straight line depreciation (without inflation adjustment) and of the capital gain income which the individual taxpayer realizes on disposition of his investment. The combination of these preferences, together with the catch-all preference for passive investment losses, will entirely erode the value of these tax incentives and dry up the capital available for any rental housing development, until there is a sufficient rise in rent levels to permit that development to operate on a positive cash flow basis. Until then, the market will concentrate on income producing properties (given that builders of rental housing can easily produce offices or condominiums instead) to the detriment of lower income housing.

Conclusions

Because it treats real losses as a tax preference, the proposed alternative minimum tax contained in H.R.3838 is inconsistent with an income tax system which requires that legitimate expenses incurred in the conduct of a trade or business be deductible. This new minimum tax is, in effect, an inequitable excise tax on certain selected business which operate as partnerships or in other forms of direct ownership structure.

In addition, H.R. 3838 protects the tax incentives which are currently in the law for home ownership at the same time that it removes, or undercuts by way of this proposed alternative minimum tax, all of the tax incentives which Congress has traditionally recognized as necessary for the continued production of rental housing. Without these incentives, rental housing will not be able to compete in the capital markets with alternative investments, leading to a sharp decrease in new construction of rental housing, to a renewed rental housing shortage and, ultimately, to rent increases estimated at more than 20% above currently anticipated levels after five years.

Moreover, because of the retroactivity of this penalty tax, it will dry up not only the supply of new capital for rental housing, but also much of the existing equity capital, threatening not only future housing stock but our existing resources. Thus, the short term effect of this new alternative minimum tax will be to transform our country from the best housed nation to one of the worst. Only when a shortage of housing has forced rents to levels which can support dramatically more expensive of capital will any significant rental housing production resume.

Accordingly, the National Multi Housing Council believes that the new alternative minimum tax will seriously impair our nation's ability to provide decent and affordable housing to lower income families and will ultimately cause rent increases which far outweigh any tax cut savings provided to the renter population. Because the renter population has only approximately one-half the income of homeowners, H.R.3838 will have the effects of a substantial tax increase in the form of increased rents for poorer families and a substantial tax cut in the form of lower rates for the more affluent homeowner population. The National Multi Housing Council believes that tax reform should not become the vehicle for this reversal of our long standing national priority to provide adequate, decent and affordable housing to our poorer citizens.

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February 13, 1986

The Honorable Bob Packwood
United States Senate
Washington, D.C. 20510

Dear Senator Packwood:

This letter concerns Section 501 of H.R. 3838 and the application of the alternative minimum tax to limited partnership losses.

Section 501 of H.R. 3838 requires that losses realized by a limited partner in a limited partnership constitute a tax preference for purposes of the alternative minimum tax. Under H.R. 3838, such treatment occurs without regard to the date on which the investment was made in the limited partnership and irrespective of the fact that one or more of the limited partners may also be a general partner in the same enterprise.

Family groups typically invest on a joint basis in limited partnerships, particularly those engaged in small business. For example, one member of the family (i.e, an adult son) may be designated as the general partner, whereas other members of the family (i.e., a retired father and his spouse and/or children) may be designated as the limited partners. The adult son may also participate in the enterprise as a limited partner.

For reasons of convenience and insulation from tort or other liability, the father (as well as other members of the family) may take their interest in the project in limited partnership form. On the other hand, while not bearing responsibility (as does the general partner) for final business decisions, all family members (particularly the father in his personal capacity and/or as trustee for trusts for his children or his grandchildren who may be limited partners) play an active role in counselling with respect to the business. In no respect are the limited partners, such as the father, detached from the operations of the partnership business, even though their legal liability may not extend to that of the general partner.

The alternative minimum tax was designed to treat as a preference investments by third party persons which are effectively comparable to passive portfolio investments in corporations. In those instances, the limited partner bears no direct familial or other business relationship with the enterprise but simply anticipates a yield, including tax deductions attributable to his investment. In the family form of limited partnership, above described, the contrary is true. Treatment of family members as detached limited partners flies in the face of the business facts and severely penalizes this important category of investment.

For these reasons, it is strongly urged that Section 501 of H.R. 3838 be amended to ensure that losses realized in a family-type limited partnership do not constitute a tax preference for purposes of the alternative minimum tax.

Sincerely,

Leonard L. Silverstein

LLS/cji

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February 12, 1986

Honorable Bob Packwood
Chairman, Committee on Finance
United States Senate
SD-219 Dirkson Senate Office Building
Washington, D.C. 20510
Att: Ms. Betty Scott-Boom

House Ways and Means Committee Tax Reform Bill of 1985

Nondeductibility of Section 212 Expenses for Alternative Minimum Tax Purposes

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My dear Senator Packwood:

As you know under current law, an individual taxpayer's ordinary and necessary expenses

(1) for the production or collection of income;
(2) for the management, conservation, or maintenance ofproperty held for the production of income; or
(3) in connection with the determination, collection, or refund of any tax

are deductible under Section 212 of the Internal Revenue Code in arriving at taxable income but are not allowed as a deduction for alternative minimum tax purposes.

The Treasury II tax reform proposal groups all expenses of this type with employee business expenses into a single category and, to the extent that they exceed one percent of the taxpayer's adjusted gross income, allows their deduction in arriving at the taxpayer's final adjusted gross income. Thus under Treasury II these income related expenditures would be allowed in computing the alternative minimum tax as well as the regular income tax.

The Tax Reform Bill of 1985 as passed by the House retains Treasury II's one percent floor on miscellaneous itemized deductions but does not treat the excess as a deduction in arriving at adjusted gross income nor as an alternative tax itemized deduction. Thus such expenses will not be deductible in computing the alternative minimum tax under the House bill.

A significant number of higher bracket taxpayers will be subject to the alternative minimum tax under the House Tax Reform Bill than under present law. Accordingly the alternative minimum tax would be paid on taxable income which is not reduced by deduction of the expenses of producing that income or for the management, conservation or maintenance of property held for the production of that income.

For taxpayers who derive a major part of their income from invested funds, fees paid for investment advisory services, for financial planning and for custody charges in connection with their investments will not be deductible even though the services were incurred to produce or increase income.

There would seem to be no theoretical justification for the position taken by the House Reform Bill and it is hoped that the position set forth in Treasury II can be reinstated in the Senate and in the Law as finally enacted.

Very truly yours,

John L. Casey/pf
Managing Director

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February 14, 1986

Ms. Betty Scott-Boom
Committee on Finance
SD 219, Darksen Senate
Office Building
Washington, D.C. 20510

RE: Tax Reform: Alternative Minimum Tax

Dear Ms. Scott-Boom:

This statement is written to you in response to Senator Packwood's request for written statements concerning the alternative minimum tax ("AMT") provisions of the tax reform proposals.

This statement is to provide input specifically regarding the disallowance of excess passive activity losses. As you are aware, the ability of a taxpayer to deduct passive activity losses would be severely curtailed in two areas. First, passive losses, whether generated from a tax shelter or not, would be limited to the amount of cash invested. Secondly, passive losses generated from a tax shelter would be limited to cash invested or $50,000, whichever is lesser.

I believe this provision to be poorly conceived at best. The proposal ignores the need for incentives for investment and provides arbitrary limitations. The remainder of this statement will address history of other provisions effecting this area, the proposals anticipated effect on investment, the arbitrary limitations and my own proposals for change. This statement addresses the issues from the point of view of the real estate industry and, in particular, real estate syndication.

Real Estate Syndication

For years, the real estate syndication industry has provided necessary capital in many diverse areas. Monies have been provided for new construction and rehabilitation. Residential, commercial, industrial and recreational properties have all been involved. The capital provided by this industry has been extremely important in spurring the real estate segment of the economy. There is no need to mention the importance of the real estate area of the economy as it relates to the construction industry. Furthermore, real estate provides a large segment of the gross national product, employs millions of people and spurs economically viable investments.

Without the real estate syndication industry providing necessary capital, it does not take an economic wizard to deduce that less money will be invested in real estate, less construction will be commenced, the GNP will be reduced and unemployment will rise. The real estate syndication industry is a multi-billion dollar industry that is vital to the economy of the United States.

The industry, as it stands today, is operating profitably and has not been an area for abuse from a tax avoidance standpoint. The industry raises capital by offering economically viable investments that provide a tax incentive write-off over a projected period of time. Investors have been attracted to the tax incentive portion of the industry as well as the opportunity to invest in real estate without a tremendous net worth or knowledge. The industry attracts many working people who are not substantial enough to purchase an entire real estate project on their own, but would like to invest in some real estate, relying upon the expertise of others. These people are predominately those who are investing in the real estate syndication industry. Without incentives to attract their capital, the industry will suffer hardships which will directly relate to investment in real estate in general.

By eliminating one of the incentives for investment in real estate syndication, the real estate industry will be adversely affected. Furthermore, many people will be deprived of the opportunity to invest in real estate because a vehicle commonly used will be severely limited and unable to compete with other investments. Additionally, potential investors will not have the expertise, knowledge or time to directly invest in real estate that was not a passive investment.

Previous Tax Legislation

In the past ten years, many code provisions, regulations and court cases have removed almost all "abuses" in the real estate area. Losses are limited in many respects. First, investment interest deduction limitations exist that curtail abusive practices. Section 163(d) of the Code. Secondly, in order to deduct certain loss allocations, such allocations must have substantial economic effect. Section 704(b)(2) of the Code.

In order to depreciate real estate that is leveraged, the purported value of such real estate must be supported by competent appraisals. Limitations exist concerning disguised sales of property and disguised services between partners and partnerships.

Depreciation tables have been increased since 1980, concerning both the real and personal property portions of real estate. At-risk rules are proposed to effect real estate which are reasonable and should be applied.

Original issue discount rules have been expanded to cover seller financed acquisitions in real estate. This effectively destroyed one of the most abusive tax shelters.

All of the above-referenced legislations and cases have removed the abuses in real estate investment and have forced many of the people who abused the law out of the real estate syndication industry. They have been well founded and generally good for the industry.

However, the current proposal is not reasonable, not supportable and not justifiable in relation to the harm it may generate.

The Proposed Provision

The proposed provisions address passive activity losses. These are activities in which an investor may not have the capital, expertise or time to invest on an active basis. These activities provide opportunities for investors to broaden their proposals, provide long-term growth and correspondingly spur increases in the GNP.

The proposed provisions pigeonhole three types of investments:

(i) tax sheltered passive activity losses;

(ii) non-tax sheltered passive activity losses; and

(iii) losses generated in activities which the investor materially participates.

The last category predominantly applies to the wealthy investor who participates in real estate alone, and accordingly he materially participates. This investor is excluded from the effect of these provisions, and accordingly may continue to take large tax sheltered losses. The largest potential abuser in this area, if an abuser at all, is not even covered by the provisions. He may structure a highly leveraged investment to provide a 2 or 3 to 1 write-off on his cash investment without being effected by the proposal.

However, the smaller investor who for various reasons, usually financial, cannot materially participate on a grand scale is seriously prohibited from making viable real estate investments that have some tax oriented advantages. This is patently unfair and hypocritical.

The provisions provide that passive activity losses are limited to cash invested, and tax sheltered passive activity losses are further limited to $50,000 of cash invested. This provision thoroughly ignores the concept of leverage which has been the cornerstone of real estate investment in the twentieth century. More capital will be needed to make investments which could severely limit the amount of capital available for real estate investment. By leveraging one's position in real estate, of course more losses will be generated. But the losses are economic in nature. Operating losses must be covered with other capital of the investor. Depreciation is the obsolescence of property over a given period of time and has been recognized for years. Why doesn't Congress just eliminate depreciation. That is effectively what these provisions will accomplish. Depreciation losses on a breakeven property from an operational standpoint will essentially be limited to cash invested. This effectively destroys the advantages of leverage, credit and depreciation in these types of activities.

It appears to this respondent that the proposal in this area favors the large hands-on investor, discriminates against the investor who can only afford to invest through real estate syndication and is ill-founded. If real estate investment is reduced to provide internal rates of return equal to investment in a financial institution, or close thereto, investment in real estate will be curtailed because of the risk involved in such an investment.

Even if the provisions are supportable in theory, which they are not, they provide artificial limitations. Where was the limitation on cash invested only drawn from? Are all tax shelters in excess of a one to one write-off abusive? Of course not. Many shelters that provide three or four to one write-offs may be abusive. However, in the last two years, most real estate investments in the initial one or two years provide approximately two to one write-offs, which even out over a five-year period of approximately a one to one write-off. These are not abusive.

Even if a limitation on cash invested exists, why limit that to $50,000 cash invested on tax oriented investments? The cash invested limitation is prohibitive enough. Why limit losses to $50,000 on a $60,000 investment? There is no rational support for this. The $50,000 figure is arbitrary, has no economic significance and discriminates against real estate syndications as vehicles for investment. An alternative may be to limit passive activity losses to cash invested and not differentiate among the vehicles utilized for such passive investment.

The proposal also provides an absolute prohibition in the year incurred to such passive activity losses. If these excess losses are only provided to wealthier investors, isn't it feasible to include them in the alternative minimum tax formula as preference items subject to the 20% or proposed 25% alternative minimum tax? I believe that this may be a viable alternative consistent with the rationale of other tax preference items.

The provision provides no mechanism for transition. Furthermore, previous years investments are retroactively affected. An investor who made an investment based on certain projected returns will not receive them beginning in 1986. The provision should at least contain some transitional and grandfather provisions similar to those proposed for investment interest limitations that contain a 10-year phase-in. (Please note that I believe that the proposed investment interest limitations provisions are ill-advised.)

In Senate Finance Committee hearings Senator Packwood complained to a lack of viable alternatives. This statement provides three such alternatives, to wit: (i) eliminate the $50,000 ceiling; (ii) treat excess passive activity losses as preference items subject to alternative minimum tax; and (iii) provide transitional rules.

This statement is respectfully submitted for your perusal. I shall make myself available to provide testimony. Please contact me if you wish to discuss this further.

Very truly yours,

Richard A. Weintraub

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